

Washington Law Review

Volume 38 | Number 1

4-1-1963

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Carl J. Bradshaw

University of Washington School of Law

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Carl J. Bradshaw, *Joint Ventures in Japan*, 38 Wash. L. Rev. 58 (1963).

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JOINT VENTURES IN JAPAN

CARL J. BRADSHAW*

INTRODUCTION

In most aspects of establishment and operation, joint venture corporations do not differ from any other corporate enterprise. A joint venture operating in a foreign country encounters daily problems of negotiable instruments law, property law and insurance law, to name but a few, in the same way that every corporation in that country does. Thus, it may seem presumptuous to write about joint ventures in a particular country unless one is willing and able to produce a comprehensive survey of that country's legal system.

There are several areas of the foreign law, however, which are primary, in terms both of importance and of chronology, since the ground rules in these areas will govern the methods of establishment and operation and, indeed, are fundamental to the basic management decision of whether or not a joint venture operation would be practicable and profitable. Clearly, primary consideration must be given to matters of foreign exchange and foreign capital, company law, taxation, and in most cases matters of industrial property rights, as well as any special laws or aspects of laws relating to foreigners. The structuring of a joint company in the maze of interrelating rules in these legal areas might become quite a special problem. Not infrequently aspects of property law, anti-monopoly law and social and labor legislation also require special attention prior to establishment.

Without gainsaying that, depending upon the industry and the particular circumstances of the parent companies involved, the law in other areas might take on special significance, still it seems that in the establishment of joint ventures involving foreign interests in Japan virtually ninety per cent of the time and effort is directed into three major areas: foreign exchange and foreign capital control, company law and taxation. Certain patterns of inquiries and problems in these three areas have arisen with sufficient frequency that they may be regarded as typical or fundamental and it is some of these that are discussed hereinafter in the hope of making clear for prospective joint venturers in Japan at least the broad contours of the legal environment.

* Associate Professor of Law, University of Washington.

CURRENCY CONVERTIBILITY AND RESTRICTIONS ON FOREIGN
EQUITY HOLDINGS.

Japan has recently announced her intention of undertaking the obligations of Article VIII of the Articles of Agreement of the International Monetary Fund. This move, which has been anticipated for two or three years, will require several steps in the direction of currency remittability. However, "full" convertibility in the popular sense need not, and probably will not, be immediate. This is discussed in Part V, *infra*. It is equally important to understand the tenor of the current restrictions, which have stood for several years, since it is from this basis that the liberalizations will evolve.

Article VII of the Treaty of Friendship, Commerce and Navigation with Japan specifically provides for the right of nationals and companies of the United States to organize companies under the laws of Japan and to acquire majority interests in such companies.¹ As a practical matter, however, considerations based upon the effects of the foreign exchange and foreign capital control laws of Japan are such that this treaty right is sometimes of little applicable value.

Although it is an American entrepreneur's legal right to form a corporation in Japan and to own 100% of it, it does not follow from any treaty provisions that he may remit in foreign currency the profits of that corporation as dividends or in another form or that he may repatriate the capital initially invested when the time comes. In order for him to have this right, he must have received the approval of the appropriate Japanese governmental authorities before paying into the capital of the joint venture company. This is so provided in the Law Concerning Foreign Investments (hereinafter cited as *Foreign Investments Law*).² This approval is generally referred to as a "validation," a translation of the Japanese *ninka*. The problems involved in obtaining this validation and the restrictions which are generally imposed upon the extent of the foreign equity holding are discussed hereafter.

In the case of an American corporation which wishes to establish a sub-subsidiary in Japan through the medium of a subsidiary in a third foreign country, the situation will not be different legally if validation for remittance of dividends and repatriation of capital in foreign currency is desired than if the Japanese corporation's shares were held

¹ Treaty of Friendship, Commerce and Navigation with Japan, April 2, 1953, art. VII, (1953) 2 U.S.T. & O.I.A. 2063, 2069 T.I.A.S. No. 2863.

² *Gaishi ni Kan-suru Hōritsu* (Law Concerning Foreign Investments), Law No. 163 (May 10, 1950), as amended, arts. 9.2, 15-2 *et seq.*, and Cabinet Orders and regulations issued pursuant thereto.

directly by the American parent. In a case in which the validation authorizing foreign currency remittances is forgone, however, there are some differences depending on the country in which the shareholding corporation is organized. Certain foreign countries have been "designated" by cabinet order and nationals of these countries, known as "designated foreign investors," can acquire either newly issued shares of stock or existing shares, whether the payment therefor is in foreign currency or yen, without the requirement of validation by the Japanese government or even of a report to the Japanese government. A foreign investor other than a designated foreign investor, is required to report subsequent to the acquisition of newly issued shares—not a troublesome requirement. However, in the case in which it is desired to form a joint venture by the acquisition of issued shares in an existing company (relatively rare so far among foreign investors in Japan) validation would be required for a non-designated foreign investor since current regulations provide that the acquisition of existing shares by a non-designated foreign investor, by payment in foreign currency, must receive a validation, and the acquisition of existing shares by payment in yen currency by a non-designated foreign investor is prohibited.³

Further, certain industries are designated as "restricted industries" for purposes of validation. These are industries considered to be affected with great public interest, such as water works, railroads, banking, and maritime transportation, and although joint venture corporations with foreigners would not ordinarily be found in these fields, it might be noted for completeness that the acquisition of shares in these industries is subject to somewhat different procedures for non-designated foreign investors than for designated foreign investors.⁴

In recent years the incredibly rapid but sustained growth of the

³ The Cabinet Order Concerning Exceptions, etc. to Standards of Validation Based on the Law Concerning Foreign Investments, Cabinet Order No. 221 (July 1, 1952), art. 4. It is in accordance with article 4.1 that the countries are designated by the Joint Notification of the Ministers of Finance, Welfare, Agriculture and Forestry, International Trade and Industry, Transportation, Postal Services and Construction. At this writing the currently effective Joint Notification is that of October 21, 1961, designating the following 17 countries: Republic of China, Finland, Federal Republic of Germany, Greece, India, The Netherlands, Sweden, Switzerland, Thailand, United Kingdom, United States of America, Uruguay, Yugoslavia, Norway, France, Federation of Malaya and Pakistan.

⁴ Article 4 of the Cabinet Order Concerning Exceptions, etc. to Standards of Validation Based on the Law Concerning Foreign Investment, *op. cit. supra*, note 3, lists the following 19 industries as restricted: The Bank of Japan, water works, local railroads, tramways, trust banking, shipping, express business, fishery, shipbuilding, broadcasting, mining, port-harbour business, land transportation, mutual banking, long term credit banking, air transportation, electricity, gas and foreign exchange banking.

Japanese economy has evoked the active interest of many American companies which had until then been occupied solely with domestic and European operations. As a consequence of the resulting volume of inquiries addressed to attorneys in Japan and the greatly increased interest in Japanese business and law recently shown by legal and business periodicals, there has developed a general awareness of the restrictions described above, and almost every prospective foreign investor's first concern will be whether or not a validation of his share acquisition is possible and, if so, what percent of the shares will be allowed. This is a most hazardous subject on which to publish a generalization for many reasons, not the least among them being that policy changes, following the whip-lash of economic conditions, will frequently have occurred in the months intervening between the writing and the printing or publication. (The same is true of most of the other aspects of the present section, all of which are subject to rapid change; for example, the list of designated foreign investors).

At present, a foreign equity holding in a joint company of less than fifteen per cent will generally be validated automatically (providing that the company is not in a restricted industry), but such a minor foreign holding will not be regarded as joint participation in the present context. Applications for validated holdings of greater than this amount are subject to the most particular review by the officials of the Ministry of Finance and another ministry, depending upon the industry involved (but it is frequently the Ministry of International Trade and Industry which makes the decision), and the application will pass through many hands in both of the ministries before the final decision is issued.⁵ All aspects of the proposed joint venture, in the context of the national economy and the conditions of the particular industry, will be considered, and the most favorable consideration will be given to those ventures which propose to introduce technology which will contribute substantially to the betterment of Japan's balance of payments position, through the creation of an export industry or through the substitution of local production for imports, and to that which will strengthen basic industries. Further, in deciding the per cent of foreign equity holding which will be validated, the government officials will generally consider the degree of patent protection covering the technology proposed to be introduced, the availability of products or equipment similar to or substitutable for those to be produced by the joint

⁵ For a brief description of the procedures, see Bradshaw, *Selected Legal Aspects of Business in Japan*, 14 STAN. L. REV. 639, 659 (1962).

venture and the effect that will be exerted on established competitors of the joint venture products. Generally, the officials have not looked with favor on unpatented technological refinements and more sophisticated applications of known products and processes. On frequent occasions they have been receptive to complaints from entrenched competitors that the establishment of the joint venture would destroy the competitive balance then prevailing. There are many more aspects which might be considered, but the above are perhaps some of the most common.

It has generally been thought that, in the average case involving desirable but not really spectacular or essential technology, a foreign equity holding of around $33\frac{1}{3}$ per cent might be allowed. That it might be more or less than that depending on the degree of desirability of the foreign technology to be introduced is obvious from the foregoing discussion. In 1961, in a limited number of cases a foreign ownership of fifty per cent was allowed, but those cases were considered exceptional and were followed by an announcement circulated to all news media that henceforth the allowable maximum would be no more than forty-nine per cent in any case. Nevertheless, it has been reported that some fifty per cent foreign holdings were validated in 1962, and the same report indicates that the average validation of foreign shares during that year may have been about forty per cent.⁶ If the average validated foreign holding is in fact rising, it could be an indication of liberalization. On the other hand, it could be the manifestation of a policy of allowing fewer but more favorable validations.

The policy on validations is not embedded in legislation; it is pure administrative discretion, and has been revised and improvised to fit changing conditions. It might well be that by the time these words are printed the impact of increasing imports pursuant to the scheduled trade liberalization will have shifted the balance of negotiating power to the foreign investor in certain industries so that a much higher average range of validated acquisitions will be allowed, and perhaps in some surprisingly "non-essential" products.

Some American companies are willing to accept considerably less than a majority interest in a foreign joint venture—some even wish to as a matter of policy. Many of these companies have found the procedures and standards for validation to be compatible with their objectives. Other companies insist on a controlling, or at least a fifty

⁶ *Business International*, December 14, 1962, *Some Who Hit the Jackpot in Japan*, page 7.

per cent interest. As described, under present policies most of these will not find a validation of that amount available to them.⁷ Such companies may decide not to go into Japan under those circumstances. Or they may elect to forego guaranties of remittance and to establish a joint venture operation without validation and without any governmental sanctions.

This latter alternative should not be undertaken lightly, however, because it represents a legal frustration of the government's desire to pass on the admissibility of foreign capital. If great resentment were caused, bureaucratic officials might become uncooperative in the many areas of administrative discretion important to the private businessman. Japanese governmental officials and businessmen alike are accustomed to the government's leadership of and intervention in policies of private industry, and I suspect that many officials on an operational level are not aware that a foreign investor can legally establish a company in Japan without governmental permission. I know from experience that until recently many Japanese businessmen did not realize it. The likelihood of damaging interference will of course vary greatly in individual situations, but in many cases a significant investment in disregard of governmental or strong private opposition might be inadvisable, despite its unarguable legality. This will depend upon the industry, the products involved and the temper of the times, among other things, and it may be wise to minimize the initial investment by a phasing in of the operations, if possible, or by local borrowings.

Lastly, many companies wish to combine a joint venture operation with a licensing arrangement, the joint venture corporation paying the royalty or fee to the parent or a related corporation. The payment of royalties to a non-resident person or corporation, *i.e.*, an "exchange non-resident" under the terms of the Foreign Exchange and Foreign Trade Control Law (hereinafter cited as *Foreign Exchange Control Law*),⁸ whether that payment be in yen or foreign currency, is illegal unless the contract providing for the payments has been validated.⁹ Consequently, both elements of the arrangement will be subjected to

⁷ Since the governmental policies here involved reflect not only balance of payment considerations but also a quite understandable desire to chaperon the entrance of foreign capital and to limit its control of local management, it has been the policy not to grant partial validations of foreign equity holdings so as to allow foreigners to retain on an unvalidated basis the shares in excess of the validation, which together would represent controlling interest. An application must be for all of the shares proposed to be held by the foreign investor or it will be refused.

⁸ *Gaikoku Kawase oyobi Gaikoku Bōeki Kanri Hō* (Foreign Exchange and Foreign Trade Control Law) Law No. 228 (December 1, 1949).

⁹ See Bradshaw, *supra* note 5, at 650.

governmental examination and such combinations have not been well received. The government prefers that the foreign investor take one or the other—an equity interest or royalty, and preferably the latter—rather than both. A corporation organized in Japan and having its principal office there, or a registered branch of a foreign corporation, however, being an “exchange resident” under the terms of the *Foreign Exchange Control Law*, can freely license without governmental supervision for royalties in yen, since no foreign assets, foreign currency or foreign entities are involved. The proceeds, of course, would not be freely remittable. Thus, workable structures have been established in which the foreign parent set up a branch or wholly owned subsidiary in Japan, which in turn is the unvalidated shareholder of the joint venture manufacturing corporation as well as the recipient of licensing or technological assistance fees.

Even in cases in which it was not contemplated to have royalties or fees in addition to the equity share in a joint venture, if the share acquisition was unvalidated it was frequently thought advisable to set up a wholly owned Japanese subsidiary or branch as shareholder in place of direct holding by the foreign company. This is because, under present regulations, the dividends paid to a non-resident unvalidated shareholder would be paid into a blocked account, which sort of account at this writing is not withdrawable even for domestic use in Japan except for severely restricted, specified purposes.¹⁰ If the recipient of the dividends is a resident branch of a foreign corporation or a Japanese corporation, however, the proceeds will not have passed to an “exchange non-resident” under the provisions of the *Foreign Exchange Control Law* and therefore would be freely usable by the wholly owned Japanese subsidiary or branch for any legal purpose.¹¹

It is obvious that the factors outlined above have circumscribed in a very real way the practical objectives of a potential foreign investor in Japan and it has been noted that the establishment of an unvalidated joint venture company in reliance on treaty rights to do so has ultimately been shown to be largely theoretical as an alternative in many cases. If a high initial investment was required, if there were foreseeable problems such as unofficial governmental opposition to the venture and if, as the last straw, the foreign investor had no confidence that the Japanese yen would become convertible in the near

¹⁰ Cabinet Order Concerning Control of Foreign Exchange, Cabinet Order No. 203 of June, 1950, as amended, arts. 11.1(5), 5.1.2; Law Concerning Foreign Investments, art. 11.2.

¹¹ The tax consequences of these inter-corporate dividends are discussed in part IV.

future, the countervailing inducements for entering into Japan had to be strong indeed. In many cases in which an acceptable validation could not be received a need for a reappraisal of a company's motivations in wishing to enter Japan was indicated.

At this time, the regulations described above still stand. The commitment to the obligations of Article VIII of the Articles of Agreement of the International Monetary Fund will require several revisions regarding current convertibility, but it is not clear to what extent the present structure of restrictions must be dismantled in specific ways to meet that commitment. Certainly there will be a partial liberalization, but that it need not be complete is obvious in that restrictions on capital transactions are not affected, and that many areas of wide discretion will remain inherent in the difficulty of distinguishing capital transactions from current transactions.¹²

THE ESTABLISHMENT OF A COMPANY

Establishment and operation of a joint venture company pose many problems in Japanese corporation law—problems to which clear answers are not yet available. While these matters and other issues which are frequently raised in joint venture negotiations can only be highlighted here, it may be helpful nevertheless to begin with a brief sketch of the historical development of Japanese company law.¹³

Historical Sketch. Business associations were not unknown in Japan in the days before the Meiji Restoration and the debut of Japan as a modern commercial nation. Probably, however, all of these pre-modern arrangements were of a pure partnership or loose association form.¹⁴

The first general company law, promulgated in 1890 as a part of what is known as the "old" *Commercial Code*, was a mixture of French and German concepts. Parts of this code were enacted, but not the entirety, due to the famous dispute between the French law partisans and the German law partisans. The German law advocates prevailed, however, and in 1899 the *Commercial Code*, including Book II on company law, was enacted. The code was based almost purely on the German *Commercial Code* of that day. In 1911 and 1938 entirely new company laws were enacted and, the close commercial relationships

¹² See text accompanying notes 195-197 *infra*.

¹³ On Japanese corporation law in general, see Fagan & Calhoun, *Japanese Corporations*, 17 BUS. LAW. 346-56 (1962). See also Blakeney, *Legal Aspects of Private Investment in Japan*, 3 INSTITUTE ON PRIVATE INVESTMENT ABROAD 263, 290-95 (1961).

¹⁴ 1 TSUDA, KAISHA HO NO TAI 10 (1959).

which soon developed with England and the United States having induced a receptivity to Anglo-American legal concepts, in the 1938 reenactment the articles on company law greatly increased in number and the Anglo-American influence was manifested in the inclusion for the first time of provisions on convertible debentures and non-voting stock.

During the occupation after World War II, a pervasive revision of the Japanese company laws was undertaken and this resulted in the amendments of 1950.¹⁵ The Illinois corporations code was chosen as an example. The major changes introduced by the 1950 amendments were the concepts of an authorized capital limit and of no-par shares, for the purpose of facilitating the raising of capital; the strengthening of the scope of authority of the board of directors, thereby removing from the body of shareholders the complete, authoritative control which had been vested in it; and the rights of individual stockholders were strengthened, this being a reflection of the diffusion of stock ownership throughout the public as a result of the breakup of the great *zaibatsu* holding companies.¹⁶ A further revision in 1955 aimed at the correction of technical problems caused by the amalgamation of the Anglo-American system with the German-based law, and, very important to foreign investors, all provisions regarding the pre-emptive rights of shareholders on the issue of new shares were removed.¹⁷ The basic provisions of the Japanese company law are found in Book II of the *Commercial Code*.¹⁸ There exist also a great number of special laws, some relating to companies in general and some only to certain kinds of companies, the provisions of which of course take precedence over the fundamental principles of the *Commercial Code*.¹⁹

¹⁵ Previous amendments were enacted in 1948, but these were not of a fundamental nature.

¹⁶ See T. Ishii, *Japan* in FRIEDMAN AND PUGH, *LEGAL ASPECTS OF FOREIGN INVESTMENT*, and Blakemore and Yazawa, *Japanese Commercial Code Revisions Concerning Corporations*, 2 AM. J. COMP. LAW 12 (1953).

¹⁷ See text accompanying note 38 *infra*.

¹⁸ *Shōhō* (Commercial) Law No. 48 (March 9, 1899).

¹⁹ Among the most important of these special laws are the following: *Yūgen Kaisha Hō* (Limited Company Law) Law No. 74 (April 5, 1938); *Shōken Torikiki Hō* (Securities Transactions Law) Law No. 25 (April 13, 1947); *Tampo tsuki Shasai Shintaku Hō* (Mortgage Bond Trust Law) Law No. 51 (March 13, 1905); *Kaisha Kōsei Hō* (Company Reorganization Law) Law No. 172 (June 7, 1952); *Kaisha no Haitō Suru Ricki matawa Risoku no Shiharai ni Kansuru Hōritsu* (Law Pertaining to the Payment of Distributions of Interest or Profits of a Company) Law No. 64 (June 28, 1948); *Kabushiki Kaisha no Saihyōka Tsumitatekin no Shihon Kumūre ni Kansuru Hōritsu* (Law Relating to the Inclusion in Capital of Re-Evaluated Reserves of a Corporation) Law No. 143 (April 10, 1951); *Kabushiki Kaisha Igaino Hojin no Saihyōka Tsumitatekin no Shihon Kumūreim Kansuru Hōritsu* (Law Relating to the Inclusion in Capital of Re-Evaluated Reserves of a Juridical Person Other Than a Corporation) Law No. 110 (May 17, 1954); *Shasai nado Tōroku Hō* (Law for the

Types of Legal Entities. The Japanese company law provides for three types of legal entities and a special law, the *Limited Company Law*, enacted in 1938, permits the existence of a fourth type.²⁰ Each of these entities may be organized without the necessity of governmental approval simply by compliance with the procedures prescribed by law. In this respect they differ from non-commercial entities organized under the civil code, such as eleemosynary institutions, the establishment of which is subject to governmental approval.²¹ All must establish a principal office and all must register the address of that principal office as well as the addresses of any branch offices. All are juridical persons, *i.e.*, have legal personalities, and can sue and be sued.

Two of the four entities, however, in other respects correspond more nearly to a partnership in United States law. In the partnership company (*Gōmei Kaisha*)²² all members are liable without limit for the debts of the company²³ and all members have rights in management and the power to represent the company.²⁴ The alienation of a member's share requires the consent of the other members.²⁵ The limited partnership company (*Gōshi Kaisha*) differs from the partnership company in that there are members both of limited and unlimited liability²⁶ and the limited liability members have no management or representative rights,²⁷ only the right of inspection.²⁸ The alienation of a member's share requires the consent of all of the unlimited liability members.²⁹

Registration of Company Bonds, Etc.) Law No. 11 (February 18, 1942); *Shiteki Dokusen Kinshi Oyobi Kōsei Torikiki no Kahuko ni Kansuru Hō* (The Law Relating to the Maintenance of Fair Trade and Prevention of Private Monopolies, commonly called simply the Anti-Monopoly Law) Law No. 54, April 14, 1947, also should be noted. Illustrative of the type of legislation pertaining to special kinds of business are *Ginkō Hō* (The Banking Law) Law No. 21 (March 30, 1927); *Hoken gyō Hō* (Insurance Company Law) Law No. 41 (March 29, 1939); *Shintakugyō Hō* (Trust Company Law) Law No. 65 (April 21, 1922) etc.

²⁰ *Yugen Kaisha Hō* (Limited Company Law) Law No. 74 (April 5, 1938).

²¹ JAPAN CIVIL CODE, art. 34.

²² It cannot be emphasized too strongly that the translation of Japanese legal terminology into English involves an overwhelming amount of arbitrary selection. Different persons have chosen different English equivalents, and arguments over which is the most "accurate" are generally fruitless. In many cases, a concept is involved which simply does not have an English cognate and any English terminology is likely to be misleading. Writers on European law frequently employ the foreign term; in discussing Japanese legal concepts the utter void of familiarity with the language in the United States probably makes this impractical. My own choices of translation appearing in this text are for reader convenience only and are not represented to be better choices than any other. A much needed initiative in the standardization of translated Japanese legal terminology has been undertaken by Rex Coleman, Esq., of the Harvard Law School World Tax Series.

²³ COMMERCIAL CODE, art. 80.

²⁴ *Id.*, arts. 70-76.

²⁵ *Id.*, art. 73.

²⁶ *Id.*, art. 157.

²⁷ *Id.*, art. 156.

²⁸ *Id.*, art. 153.

²⁹ *Id.*, art. 154.

Although both the partnership company and the limited partnership company are legal entities, it can be seen that their close correspondence with the partnership in United States law removes them immediately from consideration for most foreign investors. The two other permissible legal entities are the stock corporation (*kabushiki kaisha*, hereinafter sometimes referred to simply as a "corporation") and the limited company (*yūgen kaisha*), both of which confer limited liability on the shareholders. The characteristics of the limited company are deemed most appropriate for small-and medium-sized enterprises and, although this type of entity has rarely, if ever, been used for a joint venture operation with foreigners, in some cases it should certainly merit consideration. A brief discussion of its salient attributes is included hereafter.³⁰ The corporate form is used almost exclusively in joint ventures with foreign interests and the burden of the discussion will concern this entity. It will be noted only in passing the way in which the limited company provisions meet many of the problems encountered in a corporate joint venture organization.

The Stock Corporation. Of the legal entities permitted by Japanese law, the stock corporation is the best suited to the needs of modern industry and finance. The limited liability of the shareholders³¹ the prohibition of restraints on the free transferability of shares,³² the requirement of recordation in public records of essential facts concerning the corporation,³³ and the various provisions of the *Commercial Code* for the protection of shareholders, particularly small minority shareholders, allow and encourage the spread of stock ownership throughout the public.³⁴ Most joint venturers select the stock

³⁰ See text accompanying notes 67-105, *infra*.

³¹ COMMERCIAL CODE, art. 200.1.

³² Discussed *infra*; see text accompanying notes 34-5.

³³ See text accompanying notes 44, 60 *infra*.

³⁴ Many of the important provisions pertaining to the rights of minority shareholders are as follows: article 168, regarding special benefits received by the promoters of the company; article 173, providing for the necessity of a court inspection in certain instances; article 237, providing for the right of minority shareholders to convene a shareholders meeting; article 256-3, providing for the right of a shareholder to demand the election of directors by cumulative voting and article 256-4, providing for the right of any shareholder or shareholders who hold at least one-fourth of the total number of issued shares to make a demand for cumulative voting even if the articles of incorporation forbid cumulative voting; article 280-2.2, regarding the special procedures which must be followed in a case in which the directors wish to confer preemptive rights on the issue of new shares to persons other than existing shareholders; article 280-10, on the shareholder's right to demand the suspension of an issuance of new shares in violation of the law, the provisions of the articles of incorporation or in a grossly unfair manner or at a grossly unfair price; articles 293-6 and 293-7, on the shareholders' right of inspection; article 294, on the right of a shareholder to request a court-appointed inspector; and the various provisions requiring special resolutions of

corporation form, and in every case an annex to the joint venture contract will be the articles of incorporation of the joint venture company. Several points of law and business custom have arisen over and over again in the negotiations concerning the terms of these articles and not infrequently purely technical points give rise to considerable discussion. By-laws are not ordinarily employed by Japanese corporations and, although there is apparently nothing in the law to prevent their adoption, many of the provisions customarily found in the by-laws of corporations in the various state jurisdictions of the United States could not be included, the same provisions being required by Japanese law to be set forth in the articles of incorporation or the powers generally granted in by-laws being in Japanese law specifically reserved to one or another of the corporate organs. Consequently, the balancing of interests between the joint venturers in the management and the procedures of the corporation will be reflected in special provisions of the articles of incorporation.

In almost every case, the parties wish to restrict the free transferability of the shares of stock. In the limited company, which was designed in its legal characteristics to fill the need for small, rather intimate entities while still preserving limited liability, the alienation of shares is restricted. Such a restriction is considered incompatible with the concept of the stock corporation, however, and article 204.1 specifically provides that, "The transfer of a share shall not be prohibited or restricted even by the provisions of the articles of incorporation." A provision written into the articles of incorporation in contravention of this injunction would be a nullity; in fact, since the articles of incorporation must receive the stamp of a notary public,³⁵ evidencing their *prima facie* compliance with legal requirements, and since the *de jure* establishment of the corporation is thereafter accomplished by registration of incorporation in the local office of jurisdiction of the Ministry of Justice,³⁶ such a provision in clear violation of the precepts of the *Commercial Code* would have to be eliminated in order to complete the incorporation requirements. Thereafter, an attempt to amend the articles to include the forbidden provision would also be refused registration. Consequently, restrictions on the transfer of joint venture company shares to third parties can

shareholders on specified matters. See note 51 *infra*. However, for reasons attributable more to custom than to law, minority shareholder's suits in Japan are not common.

³⁵ COMMERCIAL CODE, art. 167.

³⁶ *Id.*, art. 188.

only be established as an ordinary contractual obligation in the joint venture contract itself, and many elaborate provisions are found regarding the granting of first refusal rights to the other party, and the prices and times at which such offers must be made. The efficacy of such provisions is, so far as I know, yet to be tested. It is probably clear that a contractual provision stating merely that neither party can transfer its shares to a third person would be ineffective. Going a step further, the type of clause providing for first refusal rights in the other party could likely become the basis for an action in damages. Query whether or not substantial damages could be recovered in the ordinary case. A judicial injunction against transfer based on such a provision would probably be unobtainable and, even if obtainable, would likely be ineffective, for reasons concerned with Japanese civil procedure which are without the scope of the present discussion.

Closely related to the issue of free alienability of shares is the matter of shareholders' pre-emptive rights on new issues of shares. The capital stock authorized to be issued by the company must be stated in the articles of incorporation,³⁷ and the shares actually issued may be any number not less than one-fourth of the total number authorized to be issued.³⁸ A general meeting of shareholders to amend the articles of incorporation (requiring a $\frac{2}{3}$ majority) is necessary to increase the authorized capital, of course, but up to the amount of the authorization it is within the authority of the directors to declare an increase in capital and to issue new shares accordingly. The *Commercial Code* has no provisions either granting or denying pre-emptive rights to existing shareholders and a provision which required that the articles of incorporation provide one way or the other with regard to pre-emptive rights was eliminated in the 1955 *Code* revision.³⁹ Most joint venture articles of incorporation will therefore provide for pre-emptive rights, a simple provision generally being sufficient. In the absence of a provision in the articles, article 280-2.1 (5) of the *Commercial Code* provides that the board of directors may determine to whom pre-emptive rights to the new shares should be accorded. For the protec-

³⁷ *Id.*, art. 166.1(6).

³⁸ *Id.*, art. 166.2.

³⁹ In the 1950 revision of the COMMERCIAL CODE, art. 166.1(5) was amended so as to make mandatory a provision in the articles regarding pre-emptive rights. This caused a great many problems, and consequently, article 166.1(5) was deleted in the 1955 revision. Thus, charter provisions regarding shareholders' pre-emptive rights become optional. Most corporations have deleted all reference to the matter. See TSUDA, *op. cit. supra* note 14, at 398; Yonezu, *Kabunushi oyobi kabunushi igai no Mono no Shin-kabu Hikuiki ken*, 29 HOGAKU KENKYU 1046, 1069-1071 (1956); Shimizu, *Kaisha HORON*, 127 (1960).

tion of shareholders in such a case, article 280-2.2 provides that the directors must show the reason that it is necessary to grant pre-emptive rights to persons other than existing shareholders, and a special resolution of the shareholders, requiring a two-thirds majority, is necessary to validate the directors' action. In a case in which one of two shareholders holds one-third or less of the outstanding shares, of course, little protection would be afforded by this provision.

A third area in which American corporate counsel's preliminary plans frequently require revision is that of the use of contributions in kind. Article 168 of the *Commercial Code* provides that the full names of persons whose contributions are to be in the form of property other than money, a listing of the property and its value, and information on the shares to be issued in exchange, must be stated in the articles of incorporation, and article 173 requires special judicial confirmation of this transaction by a court-appointed inspector to show that a transfer of property can legally be made, that it has in fact been made, and that the property is of the value stated. This requirement, of course, extends the time necessary to complete incorporation procedures and it may be difficult to fulfill, especially if the physical assets are not within Japan at the time or if the contribution is to be of unpatented technology, in which case the fact of delivery of the technology and its value may be hard to show. Moreover, the use of a contribution in kind might raise problems in the field of taxation if it were subsequently determined that the contributed assets were overvalued or undervalued.⁴⁰

Seven or more promoters are required for the incorporation of a stock corporation.⁴¹ These promoters may be either natural or juridical persons, and, as a matter of practice, several of the individuals will generally be uninterested *pro forma* promoters. If the promoters themselves take all of the initial shares of the company, a court-appointed inspector must certify that full payment for the shares has been made. The purpose of this provision is to prevent the defrauding of subsequent creditors of the corporation and subsequent purchasers of the corporation's stock.⁴² The corporation cannot be registered, and therefore come into existence, until this inspection has been completed.⁴³ If, however, at least one person other than a promoter sub-

⁴⁰ *Hōjin ze'i no Jitsumu*, Matsui, Shizurō, 29-41 (1962).

⁴¹ *COMMERCIAL CODE*, art. 165.

⁴² See TANAKA, *KABUSHIKI KAISHA HORITSU JITSUMU* 18 (1958); *Commercial Code*, articles 173, 170.

⁴³ *COMMERCIAL CODE*, art. 188.

scribes to at least one share, then the inspection procedure is avoided and registration of the company can take place after the convocation of a constituent meeting of shareholders.⁴⁴ It is required that the articles of incorporation state the following particulars: (1) the objects; (2) the name; (3) the total number of shares authorized to be issued; (4) the par value of the shares (if appropriate); (5) the number of shares to be issued at the time of incorporation and the type of shares; (6) the minimum issue price of no-par value shares (if appropriate); (7) the seat of the principal office and of each branch; (8) the manner in which public notice will be given; and (9) the full name and permanent residence of each promotor.⁴⁵ Article 168 also requires the inclusion in the articles of incorporation, where appropriate, of a listing of any special benefits to be received by the promotors, detailed information on contributions in kind, details concerning any property which the promotors have contracted for the corporation to acquire after it comes into existence, a listing of the expenses of incorporation which are to be borne by the company and the amount of remuneration, if any, to be received by the promotors.

In closing, a word perhaps should be said about shares. Shares are generally nominative, par value shares.⁴⁶ Article 202.2 of the *Commercial Code* provides that the par value of shares may not be less than 500 yen. This is equal to about \$1.39. Consequently, most new companies issue shares at this price, although some joint venture companies prefer a par value of 1,000 yen for ease in computation. Formerly, the legal minimum was fifty yen, except for certain kinds of companies for which a lower par value share was allowed. As a result, most of the shares listed on the exchanges today are of a par

⁴⁴ *Id.*, arts. 174, 180, 188. Therefore, one other *pro forma* shareholder, not a promotor, generally participates by taking at least one share of the initial issue; this simplifies considerably the incorporation process although its efficacy in protecting later creditors and shareholders is not readily apparent. All *pro forma* shareholders can transfer their shares to the interested parties thereafter. It is not necessary to retain shares in another's name, because no provision prohibits or penalizes the reduction of the number of shareholders to one.

⁴⁵ COMMERCIAL CODE, art. 166.

⁴⁶ A situation of considerable interest from a financial viewpoint was created in 1962 when a leading Japanese company listed on the Tokyo First Stock Exchange proposed to issue a bloc of no-par value shares. Since World War II, Japanese corporations have relied heavily on frequent capital increases to secure additional capital. Some corporations had increased capital in some proportion almost once a year, on the average, until the stock market break in 1961 drove prices down to around par value, and in many cases below par. Since article 202.3 of the COMMERCIAL CODE provides that the issue price of shares having par value may not be less than par, the proposed issuance of no-par stock was designed to enable the company, whose stock had fallen below par, to accomplish a capital increase. Apparently, the plan was abandoned; see Christensen, *Japanese Equity Financing*, 38 WASH. L. REV. (1963).

value of fifty yen, and market values are considerably closer to par than they would be in comparable cases in the United States, since the frequent capital increases have tended to hold down prices. Before the market break in mid-1961, the average price of shares on the Tokyo Stock Exchange was probably around 200 to 250 yen. Consequently, if it is thought possible that the joint venture company may wish to "go public" in the future, it would be wise to select the minimum permissible par value; otherwise, the relatively high price may make new issues difficult, thereby probably prejudicing chances to induct large amounts of new capital, if that is the objective, and if the objective is the popularization of the shares with the small investor, it would likely be impossible.

Organs of the Stock Corporation. In the Japanese law, the meeting of shareholders is considered conceptually to be an organ of the corporation, and a general meeting must be convened at least once a year.⁴⁷ If a company has a semi-annual accounting period, as do the vast majority of corporations, then a shareholders meeting must be held at least twice a year.⁴⁸ The use of proxies in shareholders meetings is specifically allowed by the *Commercial Code*, the absent shareholder being required to file with the company a power of attorney (*i'ninjo*) separately for each general meeting at which he wishes to be represented by another.⁴⁹ A quorum is more than one-half of the outstanding shares entitled to vote and the majority for the passage of a resolution is more than one half of the shares represented.⁵⁰ For the passage of resolutions on certain crucial matters, however, article 343 of the *Commercial Code* provides for a special resolution, which can be passed only with the concurring votes of more than two-thirds of the shares represented at a legally constituted meeting.⁵¹ Since re-

⁴⁷ COMMERCIAL CODE, art. 234.1.

⁴⁸ *Id.*, art. 234.2.

⁴⁹ *Id.*, art. 239.3 & 239.4. These requirements may be reduced in most instances by the articles of incorporation. COMMERCIAL CODE, art. 239.1.

⁵⁰ *Id.*, arts. 239.1, 240.1.

⁵¹ Such a majority is required to adopt a resolution transferring the whole or an important part of the business of the company (COMMERCIAL CODE, art. 245.1(1)), making, altering or rescinding a contract to lease the whole of the business or for the granting of complete authority to an outsider to manage the business or for the sharing of the entire profit with an outsider (*Id.*, art. 245.1(2)), taking over the whole of another business or another company (*Id.*, art. 245.1(3)), removing a director from office, (*Id.*, art. 257.2), granting preemptive rights on the issue of new shares to outsiders (*Id.*, art. 280-2.2), issuing a stock dividend (*Id.*, art. 293-2.1), determining the conditions for the issuance and conversion privileges of convertible debentures (*Id.*, art. 341-2.2), effecting an alteration of the articles of incorporation (*Id.*, art. 342.1), effecting a reduction of stated capital (*Id.*, art. 375.1), effecting the dissolution of the company (*Id.*, art. 405) and effecting an amalgamation with another company (*Id.*, art. 408.3).

quirements for the passage of a resolution can be made stricter by providing so in the articles of incorporation, some joint venturers have wished to raise the requirements for resolutions on other matters also above the requirement of a bare majority. Examples are the payment of dividends and the compensation of directors.

The election of directors can be only by a general meeting of shareholders, including interim appointments to fill vacancies.⁵² Directors need not be shareholders, and this is true even though a contrary provision may have been included in the articles of incorporation.⁵³ There must be at least three directors⁵⁴ and the terms of office of the directors cannot exceed two years.⁵⁵ Cumulative voting may be demanded in writing by any shareholder at least five days before the meeting. Even if the articles of incorporation specifically prohibit cumulative voting, it is required by law if demanded in advance by one-fourth of the shares entitled to vote.⁵⁶ The quorum for a directors meeting is over one-half of the directors and the requirement for a resolution is the concurrence of over one-half of the directors present at a legally constituted meeting.⁵⁷ The requirements for a board of directors resolution may be made more onerous by provision in the articles of incorporation, and in some joint venture companies resolutions on some of the special matters discussed in the preceding paragraph are required to have a larger majority or unanimity of the board, as well as a later special resolution of shareholders.

Joint venture arrangements between Japanese and American parent companies present a problem which apparently does not occur frequently in Japanese domestic law and which, therefore, is inadequately provided for in the present *Commercial Code*. This is, of course, the question of the use of proxies in directors meetings. There is no explicit provision in the *Commercial Code* either allowing or prohibiting it. The weight of informed opinion is heavily against it, however. A leading authority on Japanese company law states simply that, "It is required that the director himself be present at the board

⁵² COMMERCIAL CODE, art. 245.1.

⁵³ *Id.*, art. 254.2: "The company cannot, even by the articles of incorporation, provide that directors shall be shareholders."

⁵⁴ *Id.*, art. 255.

⁵⁵ The initial directors may not have a term of over one year. *Id.*, arts. 256.1, .2.

⁵⁶ *Id.*, art. 256.3, .4.

⁵⁷ *Id.*, art. 260-2. When even numbers are involved it should be noted that only one half of the directors does not constitute a quorum, nor does only one half of the directors present constitute the majority necessary for the validity of a resolution. For example, if there are four directors, three directors constitute a quorum, and of those three directors it requires two to pass a valid resolution.

of directors meeting; he may not cause another to attend as his representative."⁵⁸ The result of this is not merely that a director's resolution established by proxy might later be challenged as invalid. The Ministry of Justice local offices will refuse to accept for registration certain acts of the corporation required for validity to be registered if it appears on the face of the minutes of the board of directors meeting that the meeting was constituted and the resolution passed only through the use of proxies. Some well established joint venture companies have several American persons assigned from the American co-venturer who can fill the American company's positions on the board. Many do not, however, or perhaps wish to fill their directorships with ranking officers of the American parent corporation who cannot be permanently in Japan. As a matter of practice, many of these companies do use proxies for board meetings when no decisions requiring registration will be taken. Decisions requiring registration are taken at some time when no proxies are needed.

There is no provision in the *Commercial Code* on the place of convocation of a directors meeting. American companies wishing to establish wholly owned subsidiaries in Japan frequently wish to provide specifically that directors meetings may be held in the United States. So far, such a provision has encountered no trouble. When it is wished to insert such a provision in the articles of a joint venture company, however, it is probably well to strengthen it against attack by providing also that the expenses and a per diem allowance for directors residing outside of the United States will be provided, since it is clear that in Japanese law it is considered not only the right but the duty of a director to attend the meetings.

A third matter, which apparently has not caused much difficulty in joint venture negotiations but which is beginning to offer considerable trouble in practice, is the contractual provision between two or more co-venturers prescribing a certain proportionate representation on the board of directors—a proportionate representation that could not be attained by the shareholders' proportionate voting power. Such provisions are very common; it is questionable whether they are enforceable. Certainly they would not be enforceable against later shareholders not party to the agreement.

The *Commercial Code* requires that a corporation have one or more directors with power of representation of the corporation.⁵⁹ There

⁵⁸ TANAKA, *op. cit. supra* note 42, at 339 (Translation mine).

⁵⁹ COMMERCIAL CODE, art. 261.

must be at least one and his name must be included in the official registration of the company.⁶⁰ The representing director or directors is authorized to perform "all judicial and extra-judicial acts relating to the business of the company."⁶¹ No officers outside of the representing director or directors are required by law. Other titles such as president, vice-president, managing director, etc., are also employed, but these titles are not legal organs of the corporation.⁶² Care is required to ensure that no person who is not intended to represent the company in contractual and in other legal relations is given apparent authority to do so, because article 262 of the *Commercial Code* provides that, "A company is liable to a bona fide third party for any act done by a director invested with a title such as president, vice-president, chief director or managing director, from which it may be assumed that he has authority to represent the company, even in cases where such person has no power of representation."

The last organ of the corporation required by law is the *kansayaku*, or "auditor." He has a term not exceeding one year⁶³ and has powers of inspection of the property of the company.⁶⁴ He is required to examine the corporate accounts which the directors propose to submit for the approval of the general meeting of the shareholders and to report his opinion.⁶⁵ He may not be at the same time a director, manager or an employee of the corporation.⁶⁶ This organ exists primarily for the protection of shareholders, but his powers and duties are poorly defined. As a matter of practice, in most corporations the auditor's function is purely ceremonial and in some Japanese corporations the post is bestowed honorarily on a distinguished outsider.⁶⁷ The American co-venturer will naturally wish to designate a local accounting firm of his selection as the public accountants of the joint venture company, and it is common to designate a partner of that firm as auditor, also. Since the company's operations are in most cases in the hands of the Japanese, there is generally no objection to the

⁶⁰ *Id.*, art. 188.2 (8).

⁶¹ *Id.*, arts. 78, 261.

⁶² See TSUDA, *op. cit. supra* note 14, at 262-3. Some Japanese companies employ the title of chairman of the board; others do not. In some instances, the Japanese co-venturer has objected to the use of the title of chairman of the board for the joint venture company on the grounds that it is unfamiliar or not customary.

⁶³ COMMERCIAL CODE, art. 273.

⁶⁴ *Id.*, art. 274.

⁶⁵ *Id.*, art. 275.

⁶⁶ *Id.*, art. 276.

⁶⁷ One writer has suggested that etymologically and functionally, "inspector" would have been a better translation for Japanese *kansayaku*. Blakeney, *supra* note 13, at 291.

American's reservation of the right to appoint the public accountant. There may be more than one auditor, and the Japanese may wish to have a second to be named by him for reasons of equality.

The Limited Company (Yugen Kaisha). Apparently, foreigners have not used the limited company very much. This type of commercial entity was first recognized in the law in 1938 by the passage of a special law supplementing the *Commercial Code*.⁶⁸ This law, also, was adapted primarily from German and English concepts. The objective in the adoption of the law was to provide a simple form of stock corporation which, while unencumbered by the formalities necessary for the vast accumulation of capital with widely diffused ownership which is a corporation, would avoid the disadvantages of the partnership company and the limited partnership company.⁶⁹

It is most appropriate for small- and medium-size enterprises and this type of organization, which must be disclosed in the name of the company,⁷⁰ accordingly does not enjoy the same prestige as the pure corporation form. In this, the heyday of public relations, this may be reason enough for its being neglected. Among its important similarities to the stock corporation are the limited liability of the shareholders,⁷¹ the separation of management and ownership,⁷² and the express authorization of the use of proxies for shareholders meetings.⁷³ This type of entity is not rare in domestic business, although a recent report of the Tax Bureau of the Ministry of Finance illustrates dramatically that few companies which could be considered large from the standpoint of capital have adopted this form.⁷⁴

However, for the same reasons that the characteristics of the limited company would appear attractive to an intimate group of entrepreneurs, this type of organization could well be considered by certain types of small joint venturers. First, the necessity for formal convocation and the presence of a quorum at both shareholders and directors

⁶⁸ *Yugen Kaisha Hō* (Limited Company Law) Law No. 74 (April 5, 1938).

⁶⁹ See 2 TSUDA, *op. cit. supra* note 14, at 681-2; ISHII, SHOHO, 557 Vol. I (1958); Hattori and Iwatore, *Kaisha Horitsu Jitsunnu*, 70-85 (1960), on the formation procedures of a limited company.

⁷⁰ Limited Company Law, art. 3.1.

⁷¹ *Id.*, art. 17.

⁷² *Id.*, arts. 25, 26, 27.

⁷³ *Id.*, art. 41; COMMERCIAL CODE, art. 239.3, .4.

⁷⁴ Of 198,396 limited companies, 153,105 had a capital of \$1,400 or less. Only one was capitalized at over \$250,000. TAX BUREAU, MINISTRY OF FINANCE, AN OUTLINE OF JAPANESE TAX, 89 (1962). Such figures are likely to be misleading since companies of whatever type are much less heavily capitalized than in the United States, but the percent of stock companies capitalized in this low range is considerably less, as shown in the report cited.

meetings is eliminated. A valid shareholder's resolution can be passed without a meeting by the obtaining in writing of the unanimous consent of the shareholders, and such a resolution has the same effect and validity as the resolution of a convened general meeting.⁷⁵ Since the use of proxies is expressly condoned by the law both for stock companies and for limited companies, this provision, while of considerable convenience, cannot be listed as a solution of one of the joint venture problems as can the like freedom with directors meetings. While there is no express provision in the *Limited Company Law* validating a director's resolution by written approval and without the necessity of a formal meeting, it has been interpreted by leading scholars that, on general principles, this can be done.⁷⁶ It is further stated that a majority, not unanimity, is all that is required.⁷⁷

Second, the identity and intimacy of the shareholders is recognized in the restriction of the alienation of shares to a non-shareholder.⁷⁸ The transfer of a share to another existing shareholder of any or all of a shareholder's portion is allowed without restriction.⁷⁹ If, however, the shareholder wishes to transfer all or a part of his shares to an outsider, he is required to notify the company in writing of the identity of the other party, the number of shares intended to be transferred and the proposed transfer price.⁸⁰ The shareholders, then, by a special resolution⁸¹ may designate a different transferee, either a member or an outsider.⁸² Only if the shareholders fail to designate a different transferee within two weeks after such notice or if the designated transferee within one week after being designated has not made a written offer to take the shares, the shareholder desiring to sell his shares to the outsider may do so, at a price not less than that mentioned in his previous notice.⁸³ If a different transferee is designated

⁷⁵ Limited Company Law, art. 42.

⁷⁶ Cf., ISHII, *op. cit.* *supra* note 69, at 568.

⁷⁷ *Ibid.*

⁷⁸ In Japanese the holders of an equity interest in a limited company are referred to as "members" (*sha'in*) rather than as shareholders, *kabunushi*. To avoid the introduction of superfluous terminology in a writing which is intended to be non-technical, however, they will be referred to herein as shareholders.

⁷⁹ Limited Company Law, art. 19.1.

⁸⁰ *Id.*, art. 19.2.

⁸¹ A special resolution requires the concurrence of at least one-half of the total number of shareholders representing more than three-quarters of the total shares. Limited Company Law, art. 48.1. This should be interpreted to exclude the shareholder wishing to transfer his shares and the number of his shares from the computation because of his private interest. *Id.*, art. 41 & 48.2; COMMERCIAL CODE, art. 239.5—240.2.

⁸² Limited Company Law, art. 19.3.

⁸³ *Id.*, art. 19.4.

by the shareholders, however, and if he makes the written offer to take the shares within one week thereafter, he becomes the transferee at the end of that period of one week.⁸⁴

A third major difference from the stock corporation is that in the limited company there is no special procedure of judicial confirmation for the making of a contribution in kind. This factor might be of substantial importance in many joint ventures. The only provisions regarding this require that contributions in kind be stated in the articles of incorporation along with a description of the property, the value of the property and the number of shares to be exchanged therefor.⁸⁵ If the value of the property received is "conspicuously" less than the value ascribed to it in the articles, the difference must be supplemented by the initial shareholders. The liability is joint and several.⁸⁷ If the property is incompletely transferred, the members and directors at the time of formation are jointly and severally liable for the difference.⁸⁸ When the contribution in kind is received pursuant to a capital increase and issue of new shares and the property is "conspicuously" over-valued, the shareholders consenting to the transaction are jointly and severally liable.⁸⁹

A fourth difference from the stock corporation of considerable significance is the fact that the shareholders of the limited company cannot be reduced to one. Otherwise, the company must be dissolved.⁹⁰ If, for some reason, it were desired to use a limited company as a wholly owned subsidiary, it would probably suffice to have one dummy shareholder.

For the convenience of those who are interested in this type of company, other important differences from a stock corporation are as follows: (5) It is less complicated to provide for incorporation expenses to be born by the company after formation;⁹¹ (6) the appointment or not of an auditor (*kansayaku*) is optional;⁹² (7) the procedures for the convocation of a shareholders meeting are simplified;⁹³ (8) the facts concerning the company and records of the company required to be published are less than for a stock corpora-

⁸⁴ *Id.*, art. 19.6.

⁸⁵ TSUDA, *op cit.* *supra* note 14, at 687.

⁸⁶ Limited Company Law, art. 7(2).

⁸⁷ *Id.*, art. 14.

⁸⁸ *Id.*, art. 15.

⁸⁹ *Id.*, art. 54.

⁹⁰ *Id.*, art. 69.1 (5)

⁹¹ *Id.*, art. 7 (4).

⁹² *Id.*, art. 33.

⁹³ *Id.*, art. 36-38.

tion;⁹⁴ (9) the articles of incorporation must list the shareholders names and the amount of their contributions, and the number of shareholders cannot exceed 50;⁹⁵ (10) there need be only one director but there may be more;⁹⁶ (11) there is no provision regarding directors meetings or the designation of a representing director. All directors represent the company unless the shareholders determine a particular director to have representative capacity;⁹⁷ (12) the issue of bearer shares and bonds is prohibited;⁹⁸ (13) ¥100,000 is prescribed as the minimum capital;⁹⁹ (14) the capital must be prescribed in the articles and all of the shares must be issued;¹⁰⁰ (15) the minimum value per share is set at ¥1,000;¹⁰¹ (16) shareholders have preemptive rights to new shares unless the articles provide otherwise;¹⁰² (17) as noted above, a special resolution requires concurrence of three-quarters of all of the shares, not merely of those present,¹⁰³ rather than two thirds of those present; (18) the directors are generally named in the articles and if they are not they are elected by the shareholders;¹⁰⁴ (19) an increase in capital cannot be accomplished by the directors alone because the stated and fully issued capital must be presented in the articles of incorporation, the amendment of which can be accomplished only by the shareholders; (20) as noted above, the limited liability of directors and shareholders may be abrogated in cases of incomplete payment for shares and gross over-valuation of contributed property.

A limited company can be merged into a stock company with court approval,¹⁰⁵ and a limited company can be changed into a stock company without merger with the unanimous consent of all the shareholders, the obtaining of certain court permissions and compliance with certain other procedural measures and special measures for the protection of creditors.¹⁰⁶

⁹⁴ *Id.*, arts. 42, 46.

⁹⁵ *Id.*, art. 8.

⁹⁶ *Id.*, art. 25. Three are required for a stock corporation; see text *supra*.

⁹⁷ *Id.*, art. 27.3.

⁹⁸ *Id.*, arts. 60.3, 64.1.

⁹⁹ *Id.*, art. 9. There is no minimum prescribed for a stock corporation.

¹⁰⁰ *Id.*, art. 6.3. Only one-fourth of a stock corporation's authorized capital need be issued; see text *supra*.

¹⁰¹ *Id.*, art. 10. It is ¥500 for stock corporation's shares; see text *supra*.

¹⁰² *Id.*, art. 51. In a stock corporation shareholders haven't preemptive rights unless the articles so state; see text *supra*.

¹⁰³ *Id.*, art. 48.

¹⁰⁴ *Id.*, art. 11. Directors are never named in the articles of a stock corporation, of course.

¹⁰⁵ *Id.*, art. 60.2.

¹⁰⁶ *Id.*, arts. 65-68.

TAXATION ASPECTS OF JOINT VENTURES

General. Japan owns the distinction of having been one of the early nations in modern history to enact a progressive personal income tax. This was in 1887; the rates ranged up to three per cent after allowances for basic exemptions. In 1899, the tax on income was applied also to corporations at the flat rate of 2.5 per cent. Until 1887, the government had derived about eighty per cent of its revenue from land taxes, and these and liquor taxes together had provided about ninety per cent of the federal take. The tax on personal and corporate income was slow to overtake the land tax and various indirect taxes as the major source of federal income, however. It was not until 1935 that the income tax (applied both to individuals and corporations) became the most important source; it was not until the decade of the 1940's that taxes on personal and corporate income together accounted for over fifty per cent of the total tax revenue.¹⁰⁷

After the close of World War II, the devastation of the nation, the widespread poverty and the rampaging inflation necessitated several immediate post-war reforms,¹⁰⁸ which culminated in the pervasive overhaul of the tax laws made in 1950 as a result of the recommendations of the mission headed by Dr. Carl S. Shoup, under the sponsorship of the occupation forces. Since 1951, however, a great many of the significant Shoup Mission reforms have been repealed, primarily the two per cent tax on retained profits of corporations (repealed except as to family companies),¹⁰⁹ and the tax on gains derived from the sale of securities by individuals. Extraordinary measures were retained or introduced regarding special depreciation for the encouragement of re-industrialization, reserves for bad debts and price fluctuation, special deductions on income derived from export sales, and in other areas where tax and fiscal measures could be employed to stimulate the economy. Also, a matter of current and primary interest to Americans, the effective rates of taxation in Japan have been reduced gradually during the past decade through a series of expanded deductions, exemptions and credits, and this may be one of the important causal forces in the sustained economic expansion which has continued long after post-war reconstruction has ceased to be a major factor.

¹⁰⁷ A concise history of Japanese taxation can be found in English at TAX BUREAU, MINISTRY OF FINANCE, AN OUTLINE OF JAPANESE TAX 1-13 (1962).

¹⁰⁸ *Id.*, at 6. The author states that in 1947, 68.2% of the returns made by taxpayers had to be reassessed by the authorities.

¹⁰⁹ Regarding the taxation of retained earnings of family companies, 14 STAN L. REV., *supra*, note 5, at 671-2.

There is a multitude of laws at present which impose tax directly or indirectly on the population, or which relate directly to those imposing tax.¹¹⁰ For present purposes the most important out of these are the *Income Tax Law*,¹¹¹ the *Corporation Tax Law*,¹¹² the *Special Taxation Measure Law*¹¹³ and the *Local Tax Law*.¹¹⁴ The *Corporation Tax Law* was enacted separately from the *Income Tax Law* in 1940. Before then, provisions on corporate and personal taxation were included in one code. While the *Corporation Tax Law* pertains to corporations and other associations, the *Income Tax Law* nevertheless contains many provisions applicable to domestic companies, such as those regarding withholding on interest and dividends, and many of importance to non-resident foreign companies receiving income from Japan.¹¹⁵ The *Special Taxation Measures Law* is what the name indicates, and comprises a mass of special, temporary measures relating to, and generally ameliorating, the provisions of many of the other tax laws. Many of these special measures have been extended several times and certain of them will probably be extended for a long time

¹¹⁰ *Shotokuzei Hō* (Income Tax Law) Law No. 27 (Mar. 31, 1947); *Hōjinzei Hō* (Corporation Tax Law) Law No. 28 (Mar. 31, 1947); *Sōzokuzei Hō* (Inheritance Tax Law) Law No. 73 (Mar. 31, 1950); *Shisan Saihyōka Hō* (Assets Revaluation Law) 1953); *Satō Shōhizei Hō* (Sugar Excise Law) Law No. 38 (June 30, 1955); *Kihat-suyuzei Hō* (Gasoline Tax Law) Law No. 55 (Apr. 6, 1957); *Buppinzei Hō* (Commodity Tax Law) Law No. 48 (Mar. 31, 1962); *Torampuruzei Hō* (Playing-Cards Tax Law) Law No. 173 (June 14, 1957); *Tsūkōzei Hō* (Travel Tax Law) Law No. 43 (Mar. 29, 1940); *Nyūjōzei Hō* (Admission Tax Law) Law No. 96 (May 13, 1954); *Chihō Dōrozei Hō* (Local Road Tax Law) Law No. 104 (July 30, 1955); *Yūka Shōken Torihikizei Hō* (Securities Transaction Tax Law) Law No. 102 (July 31, 1953); *Tōrokuzei Hō* (Registration Tax Law) Law No. 27 (Mar. 28, 1896); *Inshizei Hō* (Stamp Tax Law) Law No. 54 (Mar. 10, 1899); *Torihikishozei Hō* (Bourse Tax Law) Law No. 23 (Mar. 31, 1914); *Tonzei Hō* (Tonnage Tax Law) Law No. 37 (Mar. 31, 1957); *Tokubetsu Tonzei Hō* (Special Tonnage Tax Law) Law No. 38 (Mar. 31, 1957); *Sozei Tokubetsu Sochi Hō* (Special Taxation Measures Law) Law No. 26 (Mar. 31, 1957); *Saigai Higaisha ni Taisuru Sozeino Gemmen, Shōshu Yūyo* (Law of Exemption, Reduction or Deferment of Collection of Taxes for those Who Suffered from Disasters) Law No. 175 (Dec. 13, 1947); (National Tax Evasion Control Law) Law No. 147 (Mar. 17, 1900); *Kokuzei Tsūsoku Hō* (General Law of National Tax) Law No. 66 (April 2, 1962); *Kokuzei Chōshū Hō* (National Tax Collection Law) Law No. 147 (April 20, 1959); *Chihōzei Hō* (Local Tax Law) Law No. 226 (July 31, 1950).

¹¹¹ *Income Tax Law*, Law No. 27 (Mar. 31, 1947).

¹¹² *Corporation Tax Law*, Law No. 28 (March 31, 1947). The proper reference is to "juridical persons" rather than "corporations," since the law applies to all juridical persons, including those discussed in Part III of this article, and not merely to stock corporations. As long as this is understood, the question of proper translation becomes largely academic, and the law is frequently referred to in English as the "Corporation Tax Law." Thus, the comments in this section pertaining to corporations are generally applicable to other forms of commercial companies.

¹¹³ *Special Taxation Measures Law*, Law No. 26 (Mar. 31, 1957).

¹¹⁴ *Local Tax Law*, Law No. 226 (July 31, 1950).

¹¹⁵ *Income Tax Law*, art. 6 and 1.3, require the withholding of a tax or payment to a non-resident of, speaking generally, interest, dividends, royalties, lease income and other income items prescribed by Cabinet Order. Cf., Bradshaw, *Selected Legal Aspects of Business in Japan*, 14 STAN. LAW REV. 639, 672 (1962).

to come. This dichotomy of codes, with the imposition of yet a third special law, is a much more convenient system with which to work than would appear from the description, and the use of the special *Special Taxation Measures Law* for transitory items is a logical format.

The *Local Tax Law* provides a relatively uniform system of local taxation. There are 46 political subdivisions under the federal government of which 42 are prefectures (*ken*); the City of Tokyo is a separate unit (*Tokyo-To*), as are the Cities of Osaka and Kyōtō (*Osaka-Fu*, *Kyōtō-Fu*), and the northern island of Hokkaidō. Japan is not a federation of states; the subdivisions exist just for local governmental and political purposes, although certain aspects of local autonomy are recognized in the Constitution of Japan.¹¹⁶ Local finances are derived from taxes, from a regular annual allocation of funds from federal revenues to localities and from special federal subsidies.

A discussion of tax accounting under the Japanese system would contain much familiar vocabulary—LIFO, FIFO, straight line and declining balance depreciation, etc. The national tax rate on domestic corporations and other domestic juridical persons (including a limited company) is thirty-three per cent on the first Y2,000,000 (\$5,555) of net taxable income and thirty-eight per cent of all in excess of that.¹¹⁷ In addition to this, there are three items of local tax. The prefectures levy an "inhabitants' tax" of Y600 per annum plus 5.4 per cent of the national tax payable,¹¹⁸ and an "enterprise tax" levied at a graduated rate up to twelve per cent¹¹⁹ computed in a manner similar to the national tax, two of the significant differences being that no special deductions or exemptions relative to export income and the production of certain new products are allowed. The amount of this enterprise tax is allowed to be taken as a deduction the following year in the computation of the national tax. The "municipal inhabitants' tax" is imposed by cities, towns and villages, which are administrative units within the prefecture, at the rate of 8.1 per cent of the national corporation tax, along with a standard assessment of

¹¹⁶ *E.g.*, arts. 92, 93, 94 and 95.

¹¹⁷ Corporation Tax Law, art. 17.

¹¹⁸ In certain circumstances, this can be raised to 6.5%. Local Tax Law, arts. 51.1,

¹¹⁹ Local Tax Law, art. 72-22.1. Corporations in special industries and utilities have lower rates. The tax basis and the computation of tax is actually more complex than indicated in this text. See Local Tax Law, arts. 72 through 72-76.

¹²⁰ See text accompanying notes 178-182, *infra*.

from ¥1,200 to ¥4,000.¹²¹ It can be seen that the combination of these local taxes with the national tax results in a maximum burden on corporate profits of about fifty-six per cent. Since the amount of the enterprise tax can be deducted, however, the average annual effective rate on corporate income works out to about fifty per cent.

Most of the corporations in Japan and probably all of the major ones file on the "blue return" system, which was introduced as an inducement to management to follow modern bookkeeping methods.¹²² The submission of this return is subject to official permission, but this depends only on timely application and the maintenance of accounts in accordance with methods prescribed in regulations by the Ministry of Finance. Foreign co-venturers in a Japanese joint company generally of necessity delegate day-to-day management responsibilities to the Japanese co-venturer and thus are vitally concerned with the maintenance of accurate accounts. This constitutes an additional reason for joint companies to file on the blue return system.

¹²¹Local Tax Law, arts. 312.1, 2.

¹²² The inducement provided by tax law takes the form of making certain important privileges available only to "blue return" taxpayers:

(a) A five-year loss carry forward (for other taxpayers there is a carry forward only for casualty losses) (Corporation Tax Law, art. 9.5); (b) A one-year loss carry-back (*Id.*, art. 26-4.1); (c) The deduction of credits to bad debt reserve accounts (generally, 0.5% to 1.5% of receivables outstanding at the end of the accounting period with the limit that the total accumulated reserve not exceed 3 percent of the total receivables outstanding) (Corporation Tax Law Enforcement Regulations, arts. 14 thru 14-5); (d) The deduction of credits to price fluctuation reserve accounts (3% to 8% of the lesser of book or market value, depending on the type of item) (Special Taxation Measures Law, art. 53); as well as to (e) retirement allowance reserve accounts (Corporation Tax Law Enforcement Regulations, 15-7 thru 15-15); (f) water dearth reserve accounts (for hydro-electric companies) (Corporation Tax Law, arts. 14-6 thru 14-8); (g) special reserve accounts for repair of certain restricted equipment equipments (Corporation Tax Law, arts. 15 thru 15-6); (h) default loss compensation reserves (for commodity and securities exchange brokers) (*Id.*, arts. 14-9, 14-10); (i) unusual risk reserves (for casualty insurance companies) (*Id.*, art. 14-14); (j) Carry-forward of unused depreciation allowances for five years and (k) special accelerated depreciation on machinery for production rationalization, for experimental research in production rationalization, for commercial implementation of new technology, for exploitation of natural resources and on certain mining property, afforestation expenses and mining and manufacturing technological research association expenses (Special Taxation Measures Law, arts. 42 thru 51); (l) Special deductions applicable to income derived from exports (see *infra*, text accompanying footnotes 163-67); (m) A special exemption of income derived from the manufacture or production of certain important new products (Corporation Tax Law, art. 6); (n) A tax-saving option under the Assets Reevaluation Law (Assets Reevaluation Law, art. 56); and (o) For blue return taxpayers, tax redeterminations can be made only on the basis of errors found in the returns or in the books and accounts of the corporation (Corporation Tax Law, art. 31.1) and not, as is the case with taxpayers who do not conform to the prescribed accounting methods, on the basis of estimates based on increases or decreases of property and liabilities, of receipts and expenditures, of production, sales and other transactions, and on the size of the labor force and the scale of the business (*Id.*, art. 31.2).

Establishment of a Company; Taxation Aspects. Incorporation is not expensive in Japan, the registration tax amounting to only seven-tenths of one per cent of the paid-in capital.¹²³ The same rate of tax applies on the amounts of any subsequent capital increases, also.¹²⁴

Within two months after the establishment of the corporation, or the registration of a branch of a foreign corporation, a report to the tax office of jurisdiction must be made showing the date of incorporation, the name, business purposes, names of authorized representatives and the location of the head office or principal place of business.¹²⁵ Annexed, as appropriate, must be copies of the articles of incorporation, the incorporation registration, opening balance sheet, list of initial shareholders, and information regarding contributions in kind.¹²⁶

The desirability of obtaining permission for the submission of a "blue return" is discussed above.¹²⁷ To obtain this permission for the initial accounting period, a separate request must be filed within three months of the date of incorporation or before the end of the initial accounting period, whichever be the sooner.¹²⁸ If an application has been timely filed and neither approval nor rejection has been issued by the closing date of the current accounting period (or by the date on which an interim tax return is due in the case of an accounting period longer than six months) the application is deemed approved.¹²⁹

In the section dealing with stock corporations, *supra*, reference is made to the problems concerning the use of contributions-in-kind in the establishment of a company—problems deriving both from the commercial law and the tax law.¹³⁰ Although comparisons are difficult, the tax matters are perhaps no more difficult of solution than those in our own country. The trans-national character of the transaction does add an additional ingredient, however. This is the withholding tax imposed by Japan on the value of the shares received by a foreign individual or corporation in return for its contribution-in-kind. The tax is imposed on United States persons at the tax treaty royalty withholding rate of fifteen per cent.¹³¹ Apparently, such an issue

¹²³ *Tōrokuzei Hō* (The Registration Tax Law of Japan), Law No. 27 (March 28, 1896), art. 6.1 (3), (8)-2.

¹²⁴ *Id.*, art. 6.1 (4), (8)-3.

¹²⁵ Corporation Tax Law art. 46-4.1, .2.

¹²⁶ MATSUI, HOJIN ZEI NO JITSUMU 41 (1962). Not all of these are appropriate for the branch, of course.

¹²⁷ See text accompanying note 122, *supra*.

¹²⁸ Corporation Tax Law, art. 25.3.

¹²⁹ *Id.*, art. 25.6.

¹³⁰ See text accompanying note 40 *supra*.

¹³¹ On withholding on royalties, see text accompanying notes 158-62 *infra*. The

of stock is subsumed by the Japan-U.S. Tax Treaty definition of "royalties and other amounts received as consideration for the right to use . . . (copyrights, patents, know-how, etc.) . . . and other like property (including in such royalties and other amounts rental and like payments in respect of . . . industrial, commercial, or scientific equipment). . . .",¹³² and the withholding rate limited to fifteen per cent, although this interpretation perhaps is not compelled by the words of the Treaty. If this interpretation has in fact been adopted, then the withholding rate should be reduced to ten per cent when the Protocol amending the Treaty comes into effect.¹³³

Whether or not this tax is eligible for credit under the United States *Internal Revenue Code*, section 901, is unclear, even though Japanese taxes on royalties in the narrower sense clearly are eligible.¹³⁴ If the contribution-in-kind were made pursuant to an approved *Internal Revenue Code* 367/351 application, it seems likely that a condition of approval would be that no credit be claimed for foreign taxes incurred in the transaction.¹³⁵

Income Items Important to the Usual Joint Venture and Subject to Special Tax Treatment. As described above, the national and local taxes imposed on ordinary corporate income subject a domestic corporation or other type of juridical person to an effective rate of approximately fifty per cent. "A juridical person having its head office or principal place of business" in Japan is the definition adopted by Article 1.1 of the *Corporation Tax Law* for a domestic corporation. The same rate applies to income derived from sources within Japan of a foreign corporation which has an establishment in Japan which would constitute a "permanent establishment" under a tax treaty¹³⁶ or

authority for withholding on the consideration for a contribution in kind is found in Corporation Tax Law arts. 1.6, 1.2 (9), and Income Tax Law Enforcement Regulations art. 1.6 For a more complete explanation of these provisions, see 14 *STAN. L. REV.* *supra* note 125, at 639, 668-9.

¹³² Japan-U.S. Tax Treaty, Article VII.

¹³³ See text accompanying notes 158-59, *infra*.

¹³⁴ OWENS, *THE FOREIGN TAX CREDIT*, 47-51 (1961). At least one ruling has dealt specifically with Japanese tax on royalties: *REV. RUL.* 273, 1953-2 *CUM. BULL.* 58.

¹³⁵ On this subject, a rather unfortunate editorial mistake was made by the author in Bradshaw, *Selected Legal Aspects of Business in Japan*, 14 *Stan. L. Rev.* 639 (1962) at 670 in the first paragraph. The statement there regarding applications under *INT. REV. CODE* of 1954, §§ 351 and 367 and the fact that the United States corporation would not have "control," as defined in these sections, was intended to refer to the case in which it is intended to acquire shares in an existing company by means of an exchange of property for shares.

¹³⁶ For example, Convention with Japan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income Between Japan and the United States of America, April 16, 1954 (1955) 1 *U.S.T. & O.I.A.* 149, *T.I.A.S. N.*, 3175 art. II (C).

a type of business defined in the *Corporation Tax Law*. A foreign corporation which has no permanent establishment or business in Japan is subject to a lower rate of tax on items of income derived from within Japan and specified in *Income Tax Law* article 1.3.¹³⁷

¹³⁷ Income Tax Law, art. 1.6 so provides. Art 1.3 reads as follows:

- "(1) Income from such assets, trade, business or profession as are held or carried on or exercised within the enforcement area of this Law; (excluding the income falling under item (2) to item (9) inclusive);
- "(2) Interests on government or local government bonds, or on debentures issued by a corporation having its head office or principal business place within the enforcement area of this Law.
- "(3) Interests on deposits (including savings or others of similar nature; hereinafter the same) which are deposited in the business place (including office; hereinafter the same) within the enforcement area of this Law, profits of joint operation trusts which are trusted to the business place within the enforcement area of this Law, pension (excluding the pension falling under item (5) received on life insurance contracts (including postal pension contracts) concluded with a corporation having head office or principal business place within the enforcement area of this Law, or profits received on such contract of anonymous association or other contract of similar nature as prescribed by Order (hereinafter referred to as "contract of anonymous association, etc.") with respect to investment area of this Law, or profits received on such contract of anonymous association area of this Law;
- "(4) Dividends of profits or of interests during construction or distribution of surpluses, or distribution of gains of securities investment trust received from a corporation having its head office or principal business place within the enforcement area of this Law;
- "(5) Salaries, pay, wages, yearly allowances, annuities (excluding the annuities on life insurance contracts as prescribed by Order; hereinafter the same), pension, bonuses, retirement allowance or earnings of similar nature or allowances of similar nature of annuity, pension or retirement allowance (as for annuities, pension, retirement allowance and other earnings or allowances of similar nature, limited to those for service rendered for the period in which he has domicile or has residence for one year or more within the enforcement area of this Law, excluding those paid concerning the services as a member of national or local public service personnel), or income of business as prescribed by Order whose main substance is to supply personal service, received concerning the services (as for services as a member of national or local public service personnel (excluding a person who has no Japanese nationality and who has a foreign nationality; hereinafter the same), including services rendered without the enforcement area of this Law) or supply of personal services, rendered within the enforcement area of this Law;
- "(6) Royalties on the industrial property rights to use technique, manufacturing formula using a special technique and others of similar nature, or on copyrights (including projecting right to movie film) received from a person engaged in trade, business or profession within the enforcement area of this Law, in connection with such trade, business or profession carried on within the enforcement area of this Law;
- "(7) Interests received on loans for a person engaged in trade, business or profession within the enforcement area of this Law, pertaining, as prescribed by Order, to such trade, business or profession carried on within the enforcement area of this Law;
- "(8) Income from lease of immovable located within the enforcement area of this Law, of rights therein, of quarrying rights under the Quarrying Law (including all the cases where superficies or quarrying rights are established, or where use of immovable, of rights are established, or where use of immovable, of

This includes royalties and dividends paid to a foreign corporation. Any foreign corporation or corporate complex which has considerable activities in Japan must exercise care to ensure that income such as licensing royalties theretofore subjected only to the lower rate applicable to the specified income items will not become subject to full domestic corporate rates and that income derived from exports to Japan theretofore untaxed will not become similarly jeopardized by reason of the subsequent establishment of a branch or the initiation of some other type of activity there.¹³⁸ For present purposes, the discussion of joint venture operations, this problem of insulating collateral operations from taxation in Japan at domestic rates can perhaps be disposed of with a reference to the fuller discussions appearing elsewhere¹³⁹ and the assurance that the establishment of a subsidiary corporation whose activities are unrelated to the other activities of the parent will not *by itself* constitute a business establishment of the parent company in Japan which would subject it to domestic taxes on income unrelated to the subsidiary's activities.¹⁴⁰

With reference only to the tax burden of the joint venture activity itself, there are several income items which must be considered individually in projecting after-tax profits. The following types of income are common to most joint ventures:

Inter-corporate Dividends: Dividends paid to a foreign corporation from Japan are, in the absence of a treaty, subject to a flat tax of twenty per cent which is required to be withheld by the payor.¹⁴¹ However, the Japan-U.S. Tax Treaty at the present time excepts from this tax dividends paid to a United States corporation.¹⁴² Treaties with other nations allow the subjection of dividends paid from Japan

rights therein or quarrying rights is granted), or income from establishment of the mining right under the Mining Law;

"(9) Except the incomes as mentioned in item (2) to the preceding item inclusive, incomes paid as countervalue for offering of assets to the trade, business or profession within the enforcement area of this Law or such other incomes from sources located within the enforcement area of this Law as prescribed by Order."

¹³⁸ See Bradshaw, *STAN. L. REV.*, *supra* note 125, at, 663-668; Calhoun and Hoashi, *The Japanese Tax System from the Standpoint of Foreign Business*, 18 *BUS. LAW.* 503, 505-508 (1963).

¹³⁹ *Ibid.*; see also Way, *The New Japanese Approach to the Taxation of Foreign Individuals and Enterprise*, 38 *WASH. L. REV.* 145 (1963).

¹⁴⁰ *Cf., ibid.*

¹⁴¹ Income Tax Law art. 18.2, 41.1.

¹⁴² Convention with Japan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, April 16, 1954 (1955), 1 U.S.T. & O.I.A. 149, T.I.A.S.No. 3175 (hereinafter cited as Japan-United States Tax Treaty), art. XIV (C) (ii).

to corporations of those nations to a tax of from ten per cent to fifteen per cent, when there is a limit imposed at all.¹⁴³

On August 14, 1962 a Protocol revising the Japan-U.S. Tax Treaty was signed in Tokyo and on August 31, 1962, it was submitted for the advice and consent of the U.S. Senate to ratification. Article IX of the Protocol provides for its coming into force on the date of the exchange of the instruments of ratification although most of the revised provisions will apply commencing on January 1 of the year following the exchange. The Protocol, when ratified, will change the Japanese tax picture for Americans in several important respects.

Regarding dividends paid from Japan to a United States corporation, a newly-inserted article allows their taxation at a rate of either ten per cent or fifteen per cent.¹⁴⁴ The fifteen per cent rate will

¹⁴³ Convention between the Government of Japan and the Government of the State of Singapore for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, September 5, 1961, article VI (1), maximum fifteen per cent; if to a corporation which has controlled fifty per cent or more of the entire voting power of the payor corporation for six months prior to the date on which the dividend is payable, a maximum of ten per cent; Convention between Japan and India for the Avoidance of Double Taxation in Respect of Taxes on Income, June 13, 1960, no limitation; Convention between Japan and Norway for the Avoidance of Double Taxation in Respect of Taxes on Income, September 15, 1959, article VII (1), maximum fifteen per cent; Convention between Japan and Pakistan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income May 14, 1959, article VI (3), maximum fifteen per cent if the Japanese payor is owned 1/3 or more by a Pakistani company; Convention between Japan and Sweden for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, June 1, 1957, article VII (1), maximum fifteen per cent; Convention between Japan and the Republic of Austria for the Avoidance of Double Taxation with Respect to Income, December 20, 1961, article IX, maximum 20 percent or 10 percent if payor corporation is more than 50 percent owned by payee corporation.

¹⁴⁴ The Protocol to the Double Taxation Convention with Japan, article VI A, which reads as follows:

"(1) Dividends paid by a corporation of one of the contracting States to a resident or corporation or other entity of the other contracting State shall, subject to the provisions of paragraph (2), not be taxed by the former State—

"(a) at a rate in excess of 15 percent, or

"(b) when the recipient is a corporation, at a rate in excess of 10 percent if—

"(i) during the period of twelve months immediately preceding the date of payment of the dividend more than 50 percent of the stock of the payer corporation was owned by the recipient corporation either alone or in association with not more than three other corporations of such other State, provided that at least 10 percent of the stock of the payer corporation was owned by each such corporation of such other State, and

"(ii) not more than 25 percent of the gross income of the payer corporation (other than a corporation the principal business of which is the making of loans) for such period was derived from interest and dividends other than interest and dividends received from its subsidiary corporations.

"(2) Paragraph (1) shall apply only if—

"(a) the recipient of the dividends does not have a permanent establishment in the former State, or

"(b) the recipient has in the former State a permanent establishment only of the type described in the third sentence of paragraph (1)(c) of Article II and the dividends are not attributable to the trade, business, or assets of such permanent establishment.

"(3) The term 'subsidiary corporation', as used in paragraph (1) (b) (ii), means any

apply except for United States corporations which, during the twelve-month period immediately preceding the date of payment of the dividends, owned *more than* fifty per cent of the stock (either of the total stock or of all classes entitled to vote) of the payor corporation (either alone or in association with not more than three other United States corporations provided that at least ten per cent of the stock, again either total or voting, of the payor corporation was owned by each such United States corporation) and provided that not more than twenty-five per cent of the gross income of the payor corporation (excepting a corporation the principal business of which is the making of loans) during that twelve-month period was derived from interest and dividends other than interest and dividends received from its subsidiary corporations (defined as a corporation *more than* 50 per cent of whose stock (again either total or voting) is owned by the payor corporation).

Since no foreign equity participations in joint ventures of over fifty per cent are currently being validated,¹⁴⁵ the dividends remittable to United States parent corporations will be subject to withholding at the fifteen per cent rate. No rate will be applied during the first two years after the coming into force of the Protocol, however, and a rate of 7.5 per cent will apply during the third year. From the fourth year the full rate will be applicable.¹⁴⁶

The dividends declared and paid by a corporation in which the United States corporation's shares have not been validated are not allowed under present regulations to be remitted abroad, but rather must be placed in a blocked account.¹⁴⁷ Since the Protocol contains no qualification regarding remittability, the tax would apply to these blocked payments also. In the case of a wholly-owned subsidiary which in turn holds shares in an unvalidated joint venture corporation, it is frequently deemed advisable not to declare dividends from the wholly owned subsidiary since the money, while unremittable, is none-

corporation or other entity of which more than 50 percent of the stock is owned by the payer corporation.

"(4) For purposes of paragraph (1) (b) (i) or paragraph (3), the ownership requirements shall be met by ownership of the specified percentages of the total voting power of all classes of stock entitled to vote or the total value of all classes of stock.

"(5) In the event of a substantial change in the taxes of either contracting State the competent authorities of both contracting States may consult with each other to consider whether such change makes it appropriate to amend the provisions of this Article."

¹⁴⁵ See text accompanying note 6 *supra*.

¹⁴⁶ The Protocol to the Double Taxation Convention with Japan, Article IX (3).

¹⁴⁷ See text accompanying notes 10-11 *supra*.

theless lost for many reinvestment purposes in Japan. If these accounts continue unremittable after the new withholding rate becomes fully effective, such counsel would appear doubly well-taken.

The withholding tax on dividends paid to a United States corporation, when it becomes applicable, will not lower the after-tax profits for the foreign parent as much as would appear, because of the special reduction in corporate tax rates on that part of net income distributed as dividends. The national tax rate of thirty-three per cent is lowered to twenty-four per cent on that amount earmarked for dividends which corresponds to the ratio of two million yen (the lower tax bracket) to the net income; the balance of the amount earmarked for dividends, corresponding to the higher tax bracket, is taxed at twenty-eight per cent instead of thirty-eight per cent.¹⁴⁸ The local taxes, being a percentage of the national tax, would apply proportionately, except for the enterprise tax, which is computed without regard for dividends paid. Thus, the total burden of Japanese taxes on the dividend profits received by a United States parent will approximate fifty-two per cent generally; on those received by a parent in a non-treaty country the tax burden will continue to be somewhat higher, perhaps around fifty-five per cent, because of the twenty per cent withholding.

Since dividend income received by a domestic corporation from a domestic corporation is subject to a reduced rate of tax, however, the reduced rate applicable to profits earmarked for dividend payment is limited to the extent that the domestic corporation is a net payor of dividends. In other words, it is applicable only to that amount by which its profits earmarked for dividends exceed the amount of dividends it received during the fiscal year.¹⁴⁹ If it is a net payor of dividends, the dividends received need not be included in income but need only be deducted from the dividends to be paid out; and the reduced rates apply to the balance.¹⁵⁰ If the corporation, on the other hand,

¹⁴⁸ Special Taxation Measures Law, art. 42.

¹⁴⁹ Minus interest on debts incurred for the acquisition of the shares on which the dividends were received.

¹⁵⁰ To illustrate the computation, suppose that the corporation received 2,000,000 yen in dividends from other domestic corporations and had 20,000,000 yen net income all from ordinary sources—sources, that is, not favored with a special tax rate. The shareholders vote a dividend of 5,000,000 yen. The national tax would be computed as follows (ignoring the local tax):

Dividends payable (¥5,000,000) *minus* dividends received (¥2,000,000) *equals* income earmarked for dividends (¥3,000,000).

Then, income earmarked for dividends (¥3,000,000) *times* the quotient of the lower tax bracket (¥2,000,000) *divided by* ordinary taxable income (¥20,000,000) *equals* (A) (¥300,000), the amount corresponding to an annual income of not over ¥2,000,000.

Income earmarked for dividends (¥3,000,000) *minus* that amount corresponding to

is a net recipient of dividends, then twenty-five per cent of the excess of the amount of the dividends received over the amount of the dividends paid out is includible in income.¹⁵¹ In short, the excess of dividends received is subjected to a tax rate of about twelve and one-half per cent.

In the case of an unvalidated joint venture company whose shares are held for the foreign parent by a wholly-owned Japanese subsidiary,¹⁵² it can be seen that the profits of the wholly owned subsidiary will be carrying a tax burden of about 51-52 per cent or less (considering the rate reduction for the joint venture company on the income distributed and the twelve and one-half per cent tax on the dividends in the hands of the wholly-owned subsidiary). When dividends based on unvalidated share acquisitions become freely remittable, if the wholly-owned subsidiary would pass on to the foreign parent all of the dividend income received, the twelve and one-half per cent tax on dividends received would be replaced by the ten per cent withholding tax on dividend remittances to the United States,¹⁵³ reducing the burden to around fifty per cent or less.¹⁵⁴

an annual income of not over ¥2,000,000 (¥300,000) equals (B) (¥2,700,000), the amount corresponding to an annual income of over ¥2,000,000.

Ordinary income (¥20,000,000) minus income earmarked for dividends (¥3,000,000) equals balance of ordinary income (¥17,000,000). Balance of ordinary income (¥17,000,000) times the quotient of the lower tax bracket (¥2,000,000) divided by ordinary taxable income (¥20,000,000) equals (C) (¥1,700,000), the amount corresponding to an annual income of under ¥2,000,000.

Balance of ordinary income (¥17,000,000) minus that amount corresponding to an annual income of not over ¥2,000,000 (¥1,700,000) equals (D) (¥15,300,000), the amount corresponding to an annual income of over ¥2,000,000.

| | | | |
|-----|-------------------|--------|-----------|
| (A) | Y 300,000 × 24% | equals | 72,000 |
| (B) | Y 2,700,000 × 28% | equals | 756,000 |
| (C) | Y 1,700,000 × 33% | equals | 561,000 |
| (D) | Y15,300,000 × 38% | equals | 5,814,000 |
| | Total Taxes | | 7,203,000 |

The effective tax rate on the combined Y22,000,000 income is about 32.7 per cent. If no dividends had been paid out, the tax would have about Y7,696,666—an effective rate of about 35 per cent.

¹⁵¹ Special Taxation Measures Law, art. 42-2.3.

¹⁵² It will be recalled that one of the reasons an unvalidated joint venture company might be established with a wholly-owned Japanese subsidiary as shareholder for the foreign interests is that dividends payable by the joint venture company can then be freely used in Japan by the subsidiary, whereas they would be paid into a blocked account if held directly by a foreign corporation. See text accompanying notes 10-11 *supra*.

¹⁵³ Under the Japan-U.S. Tax Treaty as amended by the recent Protocol. See text accompanying note 144 *supra*.

¹⁵⁴ Ignoring for convenience the lower tax bracket, if the proportion of the joint company's income relating to the wholly-owned subsidiary's proportion of share owner-

If a branch, instead of a wholly-owned subsidiary, were used to hold the unvalidated joint company shares, the tax consequences would be somewhat different, although not greatly so in final effect. First, the Japan-U.S. Tax Treaty provisions relating to taxation of dividends paid to United States corporations are inapplicable to a corporation which has a branch in Japan.¹⁵⁵ Therefore the dividends received by the branch from the joint venture company will be subjected to tax at a rate of ten per cent (the same rate applicable to domestic corporate recipients as a withholding, but which in the case of a domestic corporation is merely a prepayment creditable against the final liability for the accounting period), which will be withheld by the payor and which will not be deductible or creditable against other corporate tax liability.¹⁵⁶ Further, remittances to the home office (when this becomes possible) will not reduce the corporate tax rate applicable to the branch's income as would be the case with a subsidiary declaring dividends.¹⁵⁷ On the other hand, however, the remittance overseas will not be subject to the withholding tax of twenty per cent for non-treaty-country corporations and ten or fifteen per cent for treaty-country corporations, since it is not a dividend. In many cases this latter advantage will balance out against the two adverse factors.

Royalties: As part of the package in the establishment of a validated joint venture, the foreign company might also have a validated licensing agreement. *Income Tax Law* article 18.2 provides that a tax of twenty per cent applies and must be withheld by the payor on royalties paid to a foreign corporation not doing business in Japan. In the case of a United States payee, however, the withholding is limited to

ship were \$200 and if \$100 of that were paid as dividends to the wholly-owned subsidiary, the effective rate of national and local taxes would be, very roughly, about forty-five per cent, or \$90.00. Ten dollars would be retained by the joint company. If the wholly-owned subsidiary had \$100.00 of other income, derived perhaps from royalties from the joint company and from previously invested profits and included \$50.00 of this in the dividend to the foreign parent (retaining \$5.00), the tax on this profit would amount to about \$45.00. The total dividend remittance of the wholly-owned subsidiary of \$150.00 would be subject to a ten per cent withholding amounting to \$15.00. Out of a combined net income of \$300 earned in Japan, a net dividend of \$135 would be received abroad and reserves of \$15 would remain in the two corporations.

¹⁵⁵ Protocol, art. VI A.

¹⁵⁶ This result occurs as follows: *Income Tax Law* art. 18.1 and .2 provides for withholding at a rate of twenty per cent on dividends paid by domestic Japanese corporations. *Special Taxation Measures Law* art. 9 reduces this to ten per cent in the case of domestic corporate recipients and foreign corporate recipients with a branch in Japan which is subject to the corporate tax. *Corporation Tax Law* art. 10.1 and .2 provides that this amount withheld is creditable against final liability under the *Corporation Tax Law* for domestic corporations but not for foreign corporations.

¹⁵⁷ The income of the branch from sources within Japan is subject to domestic corporate rates. *Corporation Tax Law*, arts. 1.1 (2), 1.3 (1) and 1.4 (1); Japan-U.S. Tax Treaty arts. II (1) (C), III (1) (1954).

fifteen per cent¹⁵⁸ and will likely be reduced to ten per cent beginning in 1964.¹⁵⁹ Other countries have similar treaty limitations.¹⁶⁰

As noted before, in an unvalidated arrangement if it is wished to receive royalties an "exchange resident" will have to be established and the royalties made payable to it.¹⁶¹ A branch will be taxable at corporate rates on its profit derived from sources within Japan¹⁶² and a subsidiary on its total profit. Consequently, the royalty amounts will be includible in income subject to the regular corporate rates.

Income Derived From Exports: At the present time, trading companies can deduct from taxable income one per cent of their gross proceeds derived from export contracts. Manufacturers are allowed deduction of three per cent of the proceeds of exported commodities. This does not preclude the one per cent allowable to the trading company on the same export transaction.¹⁶³ Producers of plant for export are allowed a deduction of five per cent of gross. In all cases the maximum deductible is limited to eighty per cent of the net profit attributable to exports. Almost all validated joint venture companies have significant export potential, since this is one of the important considerations in obtaining validation, and it seems that many unvalidated companies too have developed or can foresee an export market. This special taxation measure also mitigates the tax burden on corporate income.

This measure is applicable, however, only until March 31, 1964,¹⁶⁴ and very likely it will not be extended due to assertions of other countries that it constitutes an export subsidy. Article XVI(4) of the General Agreement on Tariffs and Trade (GATT), to which Japan acceded in 1955, provides that the contracting nations shall cease to subsidize exports of commodities, other than primary products, on January 1, 1958, "or the earliest practicable date thereafter."¹⁶⁵ As the

¹⁵⁸ Japan-U.S. Tax Treaty, art. VII (1954).

¹⁵⁹ Protocol, art. V, amending Treaty art. VII.

¹⁶⁰ Singapore, art. VIII, no tax is imposed on fair and reasonable royalties; Denmark, art. VII (1) maximum fifteen per cent; Indian, no limit imposed; Norway, art. VII (1), maximum fifteen per cent; Pakistan, art. VII (2), no tax can be imposed; Sweden, art. VI (1), maximum fifteen per cent. For complete citations to treaties, see note 143 *supra*.

¹⁶¹ See text accompanying notes 8-9 *supra*.

¹⁶² See note 157 *supra*.

¹⁶³ Special Taxation Measures Law arts. 55-57 (4).

¹⁶⁴ Special Taxation Measures Law art. 55.1.

¹⁶⁵ Special tax treatment calculated in relation to exports is generally considered as constituting a subsidy. See General Agreement on Tariffs and Trade, Basic Documents and Selected Instruments, Ninth Supplement, 1961, pages 186-187. The vast majority of subsidization in international trade occurs in regard to agricultural products. It is questionable whether the distinction between primary products and manufactures is a valid one.

effective date was not determined, several of the contracting nations, a minority, drew up a declaration prohibiting the use of export subsidies on goods other than primary products.¹⁶⁶ Since Japan is one of the countries not yet signatory to the declaration, she is not in breach, but the Japanese government is reported to have stated that the special provisions here under discussion will be allowed to expire on March 31, 1964.¹⁶⁷

Japanese Joint Ventures and Some Aspects of United States Taxation: Although Japan is one of those nations precluded from designation as a "less developed country" by the new United States Internal Revenue Act of 1962,¹⁶⁸ this legislation should have minimal effect, if any, on Japanese joint venture operations, due primarily to yen inconvertibility and, where convertibility based on validation exists, due to foreign equity restrictions which preclude existence of a controlled foreign corporation. Since most joint ventures are established with a view to long years of operation, however, there follows a brief consideration of the probable effects of the Revenue Act of 1962 after whole or partial convertibility of the yen is attained, as well as of the current situation.

First, the act specifically excludes from subpart F income, earnings and profits of a controlled foreign corporation if it is established that they could not have been distributed "because of currency or other restrictions or limitations imposed under the laws of any foreign country."¹⁶⁹ The same section requires the issuance of regulations which, at this writing, have not yet appeared. As discussed above, an unvalidated joint venture company in Japan can be set up with the joint venture shares either held directly by the foreign parent or by a Japanese branch or subsidiary wholly-owned by the foreign parent. In the latter case, the wholly-owned subsidiary would of course be a "controlled foreign corporation"¹⁷⁰ and the subpart F income received from the joint venture company and other sources would be includible in the parent company's gross income were it not for this and other exceptions. In the former case, the joint venture company itself would be a controlled foreign corporation if the United States parent held

¹⁶⁶ *Id.*, at 32-33.

¹⁶⁷ Report of the London and Birmingham Chambers of Commerce Trade Mission to Japan, *Opportunity in Japan* 19 (April 1962).

¹⁶⁸ INT. REV. CODE OF 1954, § 955(c) (3).

¹⁶⁹ INT. REV. CODE OF 1954, § 964(b).

¹⁷⁰ Because "more than 50 percent of the total combined voting power of all classes of stock entitled to vote . . ." is owned by the American parent. INT. REV. CODE OF 1954, § 957 (a).

over fifty per cent of the shares. In either case, dividends declared to the foreign parent would have to be paid into blocked accounts and would not be remittable abroad without special permission under the Japanese *Foreign Exchange Control Law*.¹⁷¹ Such permissions simply are not being granted now. It should be noted, however, that such dividends have been "distributed," in the technical words of the statute; they just are unremittable. No doubt the regulations will clear this up, since it is obvious what was intended.

If the share acquisition in the joint venture company were validated, it probably would not be a controlled foreign corporation, since fifty per cent is the maximum that has been received by a foreign investor in recent years.¹⁷² In pre-war and early post-war days, some foreign companies did acquire more than a fifty per cent validated holding, and this may again become possible as Japan moves toward fuller convertibility. However, even these acquisitions should be little affected due to the other exceptions written into the new act.

Second is the minimum distribution provision of *Internal Revenue Code* § 963, which excludes from subpart F income for any taxable year the amount earned by a controlled foreign corporation if a minimum distribution of earnings and profits is made to the United States shareholder. As discussed above, the effective tax rate on ordinary corporate income is about fifty per cent in Japan. Thus, no distributions at all should be necessary to avoid the inclusion of the earnings and profits of a controlled foreign corporation in Japan even after yen convertibility is attained.¹⁷³ However, the existence of exempt or reduced rate income items, some of which have been discussed above, might lower the effective rate to less than forty-seven per cent, in which case a minimum distribution of fourteen per cent or more of earnings and profits would be required.¹⁷⁴

¹⁷¹ Cf. text accompanying notes 10, 11 *supra*.

¹⁷² Cf. text accompanying note 6 *supra*.

¹⁷³ At this writing, regulations under this section have not been issued. However, one may probably assume that the wording of section 963 (d) (1) will not be interpreted literally. The text of this subsection in strict construction would seem to require the following formula for computation of the "effective foreign tax rate":

foreign taxes
 effective foreign tax rate equals $\frac{\text{foreign taxes}}{\text{pre-tax earnings and profits plus foreign taxes}}$

thereby, for example, reducing an effective foreign tax rate of fifty per cent to 33⅓ per cent for purposes of this section. Would such a construction not follow from the unqualified use of "earnings and profits" in both (A) and (B) of subsection (d) (1)? The reports of the Committee on Finance, United States Senate, S. REP. No. 1881, 87th Cong., 2d Sess. (1962) make it clear that this was not intended, however.

¹⁷⁴ Regarding the effect of the reduced national tax rate on income earmarked for dividends, discussed at text accompanying notes 141-154 *supra*, and the withholding tax on dividends, text accompanying note 144 *supra*, the last sentence of INT. REV.

Third, of course, is section 954(b)(4), providing that "foreign base company income does not include any items of income received by a controlled foreign corporation if it is established to the satisfaction of the Secretary or his delegate with respect to such item that the creation or organization of the controlled foreign corporation receiving such item under the laws of the foreign country in which it is incorporated does not have the effect of substantial reduction of income, war profits, or excess profits taxes or similar taxes." It is as yet unknown what will be required to satisfy the Secretary, but it would seem that, given the Japanese tax structure as described above, it should be possible to make the requisite showing.

Fourth, *Internal Revenue Code* section 960 allows the application of the foreign tax credit for amounts deemed distributed to United States shareholders.

More fundamental than the above four dispensations is the fact that much of the income derived by a wholly-owned subsidiary in an unvalidated set-up is not subpart F income and therefore will not be taxed to the United States shareholder, when yen becomes convertible, even if distribution is not made. It will be recalled that subpart F income is composed of income derived from insurance of United States risks and foreign base company income,¹⁷⁵ and that foreign base company income means (1) foreign personal holding company income, (2) foreign base company sales income and (3) foreign base company services income.¹⁷⁶ Foreign personal holding company income comprises several categories, but the types that pertain to most joint venture arrangements are dividends and royalties.¹⁷⁷ Royalties (and rents) are not within the definition if received in the "active conduct of a trade or business" from a source which is not a "related person."¹⁷⁸ A related person is defined as a corporation or other entity which controls or is controlled by the controlled foreign corporation, or is con-

CODE OF 1954, § 963 (d) provides that, "in the case of any United States shareholder, the computation of the effective foreign tax rate applicable with respect to any controlled foreign corporation or corporations shall be made without regard to distributions made by such controlled foreign corporation or corporations to such United States shareholder." Is this clause intended to eliminate the effect of a withholding tax on dividends remitted abroad in the computation of the effective foreign tax rate? S. REP. NO. 1881, *supra* note 173, at 269 would indicate not. It is clearly intended to eliminate the reduction in the effective rate due to the distribution of the dividend, however. Otherwise the reduced rate attributable to the dividend could conceivably drop the effective rate into the next lower bracket of section 963 (b), thereby requiring an additional distribution in order to meet the requirements of this section.

¹⁷⁵ INT. REV. CODE OF 1954 § 952(a).

¹⁷⁶ INT. REV. CODE OF 1954 § 954 (a).

¹⁷⁷ INT. REV. CODE OF 1954 § 541-547.

¹⁷⁸ INT. REV. CODE OF 1954 § 954 (c) (3) (A).

trolled by the same persons who control the controlled foreign corporation, by the possession of more than fifty per cent of the total combined voting stock.¹⁷⁹

In most structures established on an unvalidated basis through the medium of a wholly-owned Japanese subsidiary, that subsidiary should own at least fifty per cent of the joint venture company, if for no other reason than that the indirect credit for taxes paid by a foreign sub-subsidiary will be available.¹⁸⁰ When it owns not over fifty per cent, however, the royalties would not be received from a related person and therefore may not be considered subpart F income if the wholly-owned subsidiary has sufficient activity to constitute the "active conduct of a trade or business," however this is to be defined. In many cases, home office personnel will be attached to the subsidiary in order to assist the joint venture company on technical problems, and although this is one step removed from the vacuous corporate recipient of royalties, it is far from clear that this alone will constitute the active conduct of a trade or business. Probably it will not. If the subsidiary were also the export medium for the joint company products, or if it had a hand in domestic Japanese distribution, it is possible that this would bring the royalty income within the exclusion being discussed. It certainly should be so ruled.

Another exclusion concerning royalties, rents and "similar amounts" excepts those received from a *related person*, "for the use of, or the privilege of using, property within the country under the laws of which the controlled foreign corporation is created or organized."¹⁸¹ Income in this category is excepted even if received from a related person and without regard for active conduct on the part of the recipient corporation. Licensing fees on intangible property registered in Japan would appear to qualify without question. Fees for the use of unpatented know-how and technical assistance which cannot be subsumed under a registered patent (perhaps because no patents at all are involved; such cases are not rare) might present a problem if this language is interpreted to refer to the "location" of the property rather than to the place of its use.

Dividend income is excluded if "received from a related person which (i) is created or organized under the laws of the same foreign country under the laws of which the controlled foreign corporation is

¹⁷⁹ INT. REV. CODE OF 1954 § 954 (d) (3).

¹⁸⁰ INT. REV. CODE OF 1954 § 902 (b).

¹⁸¹ INT. REV. CODE OF 1954 § 954 (c) (4) (C).

created or organized, and (ii) has a substantial part of its assets used in its trade or business located in such same foreign country.”¹⁸² Any conceivable Japanese joint venture company will meet criterion (ii). The degree of ownership of the joint company by the wholly-owned subsidiary will determine whether or not it is a “related person” and, consequently, whether or not the dividends received are subpart F income.

“Foreign base company sales income” refers to income in whatever form derived from the purchase and sale of personal property purchased from or sold to or on behalf of a related person if the property is manufactured or produced outside of the foreign country in which the controlled foreign corporation was organized *and* is sold for use or disposition outside of that country. This would not subsume any income either of the joint venture company or of the wholly-owned subsidiary.¹⁸³

“Foreign base company services income” refers to income in whatever form derived in connection with the performance of technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial or similar services which are performed for a related person and which are performed outside of the country in which the controlled foreign corporation is created or organized.¹⁸⁴ This, too, will not cover payments for services from the joint venture company to the wholly-owned subsidiary, since the services will be performed within Japan. This provision and the exceptions regarding royalties, discussed above, together should remove from the scope of the new revenue act almost all conceivable types of licensing and service fees made payable from the joint venture company.

It can be seen that for one or another of, or combinations of, the factors noted above, the effect of the Revenue Act of 1962 on Japanese joint venture operations is not deleterious and should not become so even after yen convertibility or partial convertibility is attained. In conclusion, a further interesting and important facet should be noted, however. Contrary to what one’s initial impressions might be, when a wholly owned subsidiary is used there are good reasons from the tax standpoint for having it own more than fifty per cent of the joint company stock, if this can be negotiated. First, as already pointed

¹⁸² INT. REV. CODE OF 1954 § 954 (c) (4) (A).

¹⁸³ In view of the Japanese tax rates, it is not likely that the purchase or sale of personal property from one foreign country to another could profitably be channeled through a controlled foreign corporation in Japan.

¹⁸⁴ INT. REV. CODE OF 1954 § 954 (e).

out, at least fifty per cent must be owned if the advantages of the indirect credit for taxes paid by a sub-subsidiary are to be had.¹⁸⁵ Second, both dividends and royalties are excluded from subpart F income if received from a *related person* (i.e., controlled by over fifty per cent shareholding within the same corporate complex) within the same country as the controlled foreign corporation.¹⁸⁶ Third, when yen convertibility is attained, it might be found advantageous to dissolve the wholly owned subsidiary and transfer ownership of the joint company shares to the American parent. In such a case, the Japan-U.S. Tax Treaty, as revised, will limit to ten per cent the Japanese withholding tax on dividends paid to the parent company only if the parent company owns over fifty per cent of the paying company's shares.¹⁸⁷

YEN CONVERTIBILITY: THE END OF AN ERA?

Under the law as it has existed since 1950 the dominant considerations in the structuring of Japanese joint venture operations have stemmed from the restrictions on foreign entry derived from the laws relating to foreign exchange and foreign capital control described in the section *re* currency convertibility and restrictions on foreign equity holdings, *supra*. The recent announcements¹⁸⁸ of Japan's intention to undertake the obligations of Article VIII of the Articles of Agreement of the International Monetary Fund¹⁸⁹ have been interpreted by some as the death rattle of the expiring bureaucratic machinery which has for so long exercised preemptory authority over joint venture arrangements. This may be a not too sanguine view. It is equally probable, however, that a rather long transition period will be involved before exchange controls will have lost their relevance to the planning of ventures in Japan.

While Article VIII forbids "restrictions on the making of payments and transfers for current international transactions," restrictions may nevertheless be maintained or imposed with the approval of the Fund.¹⁹⁰ As a practical matter, the Fund would seem to have

¹⁸⁵ Note 180 *supra*.

¹⁸⁶ See text accompanying notes 181-82 *supra*.

¹⁸⁷ Otherwise, the rate will be fifteen per cent. See text accompanying note 144 *supra*.

¹⁸⁸ For example, see THE NIHON KEIZAI SHIMBUN (Japan Economic Journal) 1 (int'l weekly ed. February 12, 1963).

¹⁸⁹ Articles of Agreement, International Monetary Fund, U.S.T. & O.I.A. series 1501, Dept. of State Publication 2512 (effective Dec. 27, 1945).

¹⁹⁰ *Id.*, VIII (2) (a).

"Avoidance of restrictions on current payments.—

little choice in the event of a serious payments imbalance in Japan. The demonstrated volatility, perhaps fragility, of the Japanese economy is such that the possible necessity for retrogressive measures cannot be dismissed. The provisions of Article XII (2) of the Japan-U.S. Treaty of Friendship, Commerce and Navigation,¹⁹¹ that neither party may impose exchange restrictions "except to the extent necessary to prevent its monetary reserves from falling to a very low level or to effect a moderate increase in very low monetary reserves," would not be inhibiting since the same paragraph provides an exception in the case of restrictions authorized or required by the Fund.

The obligations of Article VIII do not include the freeing of capital transactions. Quite to the contrary, Article VI (3) specifically provides for the regulation of capital movements and Article VI (1) imposes sanctions for failure to do so when necessary.¹⁹² Thus, Japan is not

(a) Subject to the provisions of Article VII, Section 3 (b), and Article XIV, Section 2, no member shall, without the approval of the Fund, impose restrictions on the making of payments and transfers for current international transactions."

¹⁹¹ Treaty of Friendship, Commerce and Navigation with Japan, April 2, 1953, 2 U.S.T. & O.I.A. 2063, 2069 T.I.A.S. No. 2863.

¹⁹² Articles of Agreement, International Monetary Fund, VI.

"Section 1. Use of the Fund's resources for capital transfers.—

(a) A member may not make net use of the Fund's resources to meet a larger or sustained outflow of capital, and the Fund may request a member to exercise controls to prevent such use of the resources of the Fund. If, after receiving such a request, a member fails to exercise appropriate controls, the Fund may declare the member ineligible to use the resources of the Fund.

(b) Nothing in this Section shall be deemed.—

(i) to prevent the use of the resources of the Fund for capital transactions of reasonable amount required for the expansion of exports or in the ordinary course of trade, banking or other business, or

(ii) to affect capital movements which are met out of a member's own resources of gold and foreign exchange, but members undertake that such capital movements will be in accordance with the purposes of the Fund.

Sec. 2. Special provisions for capital transfers.—If the Fund's holdings of the currency of a member have remained below seventy-five percent of its quota for an immediately preceding period of not less than six months, such member, if it has not been declared ineligible to use the resources of the Fund under Section 1 of this Article, Article IV, Section 6, Article V, Section 5, or Article XV, Section 2 (a), shall be entitled, notwithstanding the provisions of Section 1 (a) of this Article, to buy the currency of another member from the Fund with its own currency for any purpose, including capital transfers. Purchases for capital transfers under this Section shall not, however, be permitted if they have the effect of raising the Fund's holdings of the currency of the member desiring to purchase above seventy-five percent of its quota, or of reducing the Fund's holdings of the currency desired below seventy-five percent of the quota of the member whose currency is desired.

Sec. 3. Controls of capital transfers.—Members may exercise such

required to revise present validation requirements with respect to capital repatriation. Article XII of the Japan-U.S. FCN treaty¹⁹³ is unlikely to afford relief also in the capital area due to its potential conflict with clearly stated IMF policy. Official sources have declared Japan's intention voluntarily to liberalize capital transactions,¹⁹⁴ and this will eventually be necessary to implement full membership for Japan in the Organization for Economic Cooperation and Development (OECD), but in the absence of an immediate obligation to do so the relaxation can be accomplished gradually and, perhaps, selectively.

The administrative machinery, nurtured by currency controls for 17 years, is far from obsolete. Accession to Article VIII involves a renunciation of unapproved restrictions, not of controls. Quite the opposite, controls are concededly necessary to the regulation of capital transactions. At the Bretton Woods conferences it was proposed that the present Article VIII be amended to include the following clarification:

While imposing no restrictions on current international payments, a member country may take the necessary measures to ensure that:

- (a) Its foreign exchange holdings and its quota are used to pay for imports which are essential to its national economy.
- (b) The proceeds of exports from the member country are placed at the disposal of its foreign exchange authorities to be used for its essential requirements thereby preventing what may, otherwise, constitute capital transfers.¹⁹⁵

The committee on exchange controls confirmed an implicit understanding by reporting that the objectives which the proposed amendment were intended to safeguard, "are fully protected under the proposed language,"¹⁹⁶ *i.e.*, the existing language, without the amend-

controls as are necessary to regulate international capital movements, but no member may exercise these controls in a manner which will restrict payments for current transactions or which will unduly delay transfers of funds in settlement of commitments, except as provided in Article VII, Section 3 (b), and in Article XIV, Section 2.

¹⁹³ See note 191 *supra*. For an excellent analysis of the effect on currency restrictions of this Treaty, see METZGER, *INTERNATIONAL LAW, TRADE AND FINANCE* 118-120 (1962).

¹⁹⁴ See note 188 *supra*.

¹⁹⁵ Proceedings and Documents of the United Nations Monetary and Financial Conference, Bretton Woods, New Hampshire, July 1-22, 1944, Department of State Publication 2866, International Organization and Conference Series I, 3, Vol. I at 279, Doc. 219.

¹⁹⁶ *Id.*, at 544-5, Report of Ad Hoc Committee of Commission I on Article IX, Section 4 (Exchange Controls on Current Payments). See Stranger, *Exchange Control*, 17 OHIO ST. L.J. 302 at 304-5.

ment. Since capital movements can be concealed in current transactions in many ways, the need to maintain administrative scrutiny of exchange transactions until capital transactions become unrestricted can hardly be disputed.

The distinction between current transaction and capital movement is not at all clear. "Payment for current transaction" is defined as follows in Article XIX (i) of the Fund agreement:

"Payments for current transactions means payments which are not for the purpose of transferring capital, and includes, without limitation:

- (1) All payments due in connection with foreign trade, other current business, including services, and normal short-term banking and credit facilities;
- (2) Payments due as interest on loans and as net income from other investments;
- (3) Payments of moderate amounts for amortization of loans or for depreciation of direct investment;
- (4) Moderate remittance for family living expenses.

The fund may, after consultation with the members concerned determine whether certain specific transactions are to be considered current transactions or capital transactions."

There is no definition of "capital transactions." An Executive Board Decision of June 1, 1960, added the tautological statement that,

The guiding principle in ascertaining whether a measure is a restriction on payments and transfers for current international transactions under Article VIII, Section 2, is whether it involves a direct governmental limitation on the availability or use of exchange as such.¹⁹⁷

The intention of the Japanese government is to complete the transition to an Article VIII nation by the Autumn of 1964,¹⁹⁸ and proposed revisions of relevant laws have not yet been worked out. It is impossible at this stage to say what restrictions will still remain at that time, but the chances are good that several important ones will.

The primary vision of the committees at Bretton Woods was to liberate international trade from unjustified currency restrictions and, in conjunction with a world trade charter, from quantitative restrictions, and the primary attention has been focused on the dismantling

¹⁹⁷ Executive Board Decision on Article VIII and Article XIV, June 1, 1960, *Twelfth Annual Report on Exchange Restrictions*, 1961, International Monetary Fund, Washington, D.C.

¹⁹⁸ See note 188 *supra*.

of import barriers. Thus, when we come to transactions involving other than commodity trade and related transactions, many questions are presented.

Are dividends based on net profits derived from the sale of capital assets current payments or capital transactions? What is meant by "payments of moderate amounts for amortization of loans"? Is a large initial payment for rights under a licensing agreement a capital transaction? May abnormally high royalties under a licensing agreement be considered disguised capital transactions? Is direct control of inward capital movements as well as of outward capital movements authorized? Probably it is clear that past payments of dividends now accumulated in blocked amounts are not "current transactions" and need not be granted remittability. To what extent might remittability be voluntarily accorded? Those more sophisticated than the writer can think of more, and better, examples. Restrictions based on domestic commercial policy, unrelated or only indirectly related to foreign currency, are also conceivable.

Given harmony and stability in international economic relations, the end of an era of restrictions is perhaps approaching. But it might be several years in coming. In the meantime, the necessary scope and difficulty of careful and prescient planning on the basis of current restrictions and probable future developments, with consideration always to the tax consequences attendant on future desirable reorganizations, may become even greater than under the current narrowly restrictive law, in which the alternatives are relatively fewer.